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The Effect of Federal Income Tax Integration on State Tax Systems

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I. Introduction

A frequently discussed tax reform suggestion of the last decade is the integration of the federal income taxes imposed on corporations and shareholders.[1] Although various methods of achieving integration have been advanced, the common goal of the advocates of integration is to eliminate, either wholly or in part, the double taxation of corporate earnings.[2] Under present law, corporate income is taxed when earned by the corporation and again when distributed as a dividend to the shareholders.[3] This double taxation presumably impedes capital formation.[4] In light of recent economic trends in the United States,[5] double taxation has come under attack by many commentators.[6]

Despite the attention given to the impact of integration at the federal level, very few commentators have focused on the effect of integration on state income taxation of corporations and individu-

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1. *See* C. McLure, Must Corporate Income Be Taxed Twice? (Brookings, Wash. D.C. 1979); Break, *Integration of the Corporation and Personal Income Taxes,* 22 Nat'l Tax J. 39 (1969); Break & Pechman, *Reflections on "Integration" of Corporation and Individual Income Taxes: Relationship Between the Corporation and Individual Income Taxes,* 28 Nat'l Tax J. 341 (1975); Byrne & Sato, *The Domestic Consequences of Alternative Systems of Corporate Taxation,* 4 Pub. Finance Q. 259 (1976); Comm'n on Corporations of the Tax Section of the N.Y. St. Bar A., *Report on the Integration of Corporate and Individual Income Taxes,* 31 Tax Law. 37 (1977); Cox, *Corporate Income Tax and Integration: A Summary of Positions and the Prospects for Change,* 58 Taxes 10 (1980); Feldstein & Frisch, *Corporate Tax Integration: The Estimated Effects on Capital Accumulation and Tax Distribution of Two Integration Proposals,* 30 Nat'l Tax J. 37 (1977); Gabinet & Coffey, *The Implications of the Economic Concept of Income for Corporation-Shareholder Income Tax Systems,* 27 Case W. L. Rev. 895 (1977); Galvin, *The Substantive Tax Reform Project: Preliminary Findings on the Corporate Tax,* 22 Sw. L.J. 717 (1968); Holland, *Reflections on "Integration" of Corporate and Individual Income Taxes: Some Observations on Full Integration,* 28 Nat'l Tax J. 353 (1975); McLure, *Integration of the Income Taxes: Why and How,* 2 J. Corp. Tax. 429 (1976); McLure, *Integration of Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals,* 88 Harv. L. Rev. 532 (1975); McLure, *The Taxation of Income from Corporate Shareholding: The Case for Integrating the Income Taxes,* 28 Nat'l Tax J. 257 (1975); McLure & Surrey, *Integration of Income Taxes: Issues for Debate,* 55 Harv. Bus. Rev. 169 (1977); Surrey, *Reflections on "Integration" of Corporation and Individual Income Taxes,* 28 Nat'l Tax J. 335 (1975). Income tax integration is not an idea of the last decade. *See, e.g.,* Nat'l Tax A., Proc. of Fortieth Ann. Conf. 134-89 (1947); Devine, *Taxing Corporations as Partnerships,* 26 Taxes 506 (1948); Westfall, *Integrating Federal Income Taxes on Corporations and Their Shareholders,* 27 Taxes 236 (1949).

2. *See, e.g.,* C. McLure, Must Corporate Income Be Taxed Twice?, *supra* note 1; Holland, *supra* note 1; McLure, *Integration of the Income Taxes: Why and How, supra* note 1; McLure, *Integration of Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals, supra* note 1.

3. I.R.C. §§ 11, 61(a)(6). Double taxation presently is offset by the $100 dividend exclusion for individuals and 85% deduction for dividends received by corporations. *Id.* §§ 116, 243-47. The earnings of certain corporations presently are taxed only once. *See* notes 90-132 and accompanying text *infra.*

4. *See, e.g.,* Harris, *Tax Equity and the Need for Capital: With Special Reference to Income from Corporate Shareholding,* 28 Nat'l Tax J. 292 (1975); Hickman, *Tax Equity and the Need for Capital,* 28 Nat'l Tax J. 282, 287-88 (1975).

5. Staff of Joint Comm. on Taxation, 95th Cong., 1st Sess., Report on Tax Policy and Capital Formation 3-4 (Comm. Print 1977) [hereinafter cited as Staff of Joint Comm. on Taxation].

6. *See* note 2 *supra.*

als.[7] Most states have not conducted major studies of the topic.[8] This article concentrates on the effect of integration at the state level.[9]

Federal income tax integration has found recent support in Congress[10] and in the Reagan administration.[11] Although it is difficult to predict whether integration will become a reality in the near future,[12] an analysis of the effect of integration on state income taxation provides additional factors that should be considered when integration is given serious attention by Congress and the public.[13]

It is not certain when consideration of the effect of federal integration on state income taxation will move into the foreground, but a related proposal deserves attention at the present time. The American Institute of Certified Public Accountants (AICPA) is studying a proposal to extend the small business corporation provisions of Subchapter S of the Internal Revenue Code[14] to all corporations that are privately owned.[15] This proposal, which in effect is similar to full integration,[16] would increase the number of Subchapter S corporations to the extent that states would need to reexamine their present treatment of Subchapter S corporations.[17] The portions of this article that discuss full integration are pertinent to determining the ef-

7. Clarke, *The Taxation of Income from Corporate Shareholding: State and Local View,* 28 NAT'L TAX J. 373 (1975); Comm'n on Corporations of the Tax Section of the N.Y. St. Bar A., *supra* note 1, at 62-63; McKessy, *Corporate and Individual Tax Reform Considered from a State and Local Viewpoint,* 28 NAT'L TAX J. 377 (1975).

8. New York is a notable exception. Its Department of Taxation and Finance has undertaken a thorough study of the effect of income tax integration on New York. Letter from James H. Tully, Jr., Commissioner of Taxation and Finance, State of New York, to James E. Maule (January 11, 1978) (on file at the Dickinson School of Law).

9. Professor Charles McLure, the leading authority and author of numerous articles and the only book on the topic of income tax integration, told the author of this article in 1978 that neither he nor anyone he knew was studying the effects of federal income tax integration on state income tax systems. The absence of any recent publications on the subject has confirmed Professor McLure's observation.

10. *See, e.g.,* H.R. 897, 97th Cong., 1st Sess. (1981) (Rep. Beard); H.R. 306, 97th Cong., 1st Sess. (1981) (Rep. Hansen); H.R. 4833, 96th Cong., 1st Sess. (1979) (Rep. Sawyer); 124 CONG. REC. H 640-42 (daily ed. Feb. 2, 1978) (remarks of Rep. Ullman).

11. *See, e.g.,* [1981] FED. TAXES (P-H) 60-165, 60-167 (Feb. 11, 1981) (remarks of Norman B. Ture, Undersecretary of the Treasury for Tax Policy).

12. *See* Cox, *supra* note 1, for a brief analysis of the political atmosphere in which decisions about federal income tax integration must be made.

13. The states anticipate that Congress will consider the effect of integration on their income tax systems when it considers integration at the federal level. *See* Clarke, *supra* note 7, at 376; McKessy, *supra* note 7, at 381.

14. I.R.C. §§ 1371-1379.

15. *See* 145 J. Accountancy, Jan. 1978, at 3. A similar study has been conducted by the Small Business Administration Office of Advocacy. *See* 144 J. Accountancy, Oct. 1977, at 24. The request for expansion and reform of Subchapter S also has been made in the commentary. *See* Peckron, *Subchapter S Shareholder Requirement: Need for a Change,* 55 TAXES 92, 95-96 (1977). Most, if not all, of the proponents of Subchapter S reform seek an increase in its use; accordingly, comments in this section about the AICPA proposal apply to all Subchapter S proposals.

16. Full integration is outlined in notes 21-25 and accompanying text *infra.*

17. Generally, states are divided on their recognition of elections by shareholders of Subchapter S corporations. *See* notes 90-99, 521-31 and accompanying text *infra.*

fects of the AICPA proposal on states,[18] since the two proposals differ only in technical aspects[19] and quantitative impact.[20]

This article discusses several major methods of integration, historical aspects of integration, and some provisions in existing federal and foreign tax law that are analogous to integration. The article then analyzes the effects of integration on the states and the possible state responses to the various methods of integration. The analysis considers the state both as a separate entity and as a member of the federal union and examines devices to preserve state income tax revenues that might otherwise be reduced by the adoption of integration at the federal level.

II. Preliminary Explanations

A. *Major Methods of Integration*

1. Full Integration.—The basic premise of the full integration method is that the shareholders of a corporation include their proportionate shares[21] of the net income[22] of the corporation in gross

18. For the purpose of simplicity, the remainder of this article does not specifically address the AICPA or similar proposals. Nevertheless, comments made with regard to the full integration proposal should be useful in determining the effects of the AICPA or similar Subchapter S revision proposals on state income taxation.

19. The differences between Subchapter S provisions and the full integration proposal are of such relatively minor importance that the analysis of one proposal is quite relevant to examination of the other proposal. For example, Subchapter S Corporations are taxed on certain capital gains, I.R.C. § 1378, whereas under full integration these gains are subject to tax at the shareholder level.

20. Full integration would affect all corporations; the AICPA or similar proposals would affect only privately owned corporations.

21. For the purpose of simplicity, this article assumes that owners of common stock would be taxed on amounts of corporate net income in proportion to their voting interests in the corporation. Income tax integration at the federal level raises the issue of how to treat owners of preferred stock and hybrid securities. *See* McLure, *Integration of Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals, supra* note 1, at 563-64, 588. Although the resolution of these issues affects the identity of the shareholders who are taxed and changes the distribution of the corporate net income, the concepts developed in this article are not significantly affected by the resolution of those issues. Although in certain circumstances one resolution of those issues might have the effect of attributing more of the distributive net income to nonresident shareholders than would another resolution, these differences are ignored in this article because the differences are relatively insignificant, and because this article assumes that any state that adopts integration will conform to the Federal resolutions of these issues.

Another group of issues at the federal level concerns the treatment of part-year shareholders and shareholders who during the year change the amount of their holdings of stock in the corporation. *See* U.S. DEP'T OF THE TREASURY, BLUEPRINTS FOR BASIC TAX REFORM 71-73 (1977) [hereinafter cited as BLUEPRINTS]. Although there are various methods of resolving these problems, this article assumes unchanging full year ownership of stock by shareholders in corporations.

22. Under the full integration method, there are unresolved questions concerning the manner in which corporate income is included by shareholders in gross income. One option is to treat the shareholders as shareholders in Subchapter S corporations are treated. *See* I.R.C. §§ 1371-1379. Another option is to treat the corporation as a conduit in much the same manner as a partnership. *See* BLUEPRINTS, *supra* note 21, at 68. *See generally* Cohen, *Problems Involved in Alternative Proposals for Integration or Reduction in U.S. Tax: Possible Solutions to Practical Problems,* 28 NAT'L TAX J. 359-60 (1975); McLure, *Integration of Personal and Cor-*

income.[23] Under the full integration method, it is immaterial whether the net income of the corporation is actually distributed to the shareholders.

One variation of the full integration method embellishes the basic proposal with a provision for withholding. The corporation is required to withhold and remit to the government a certain portion of its net income.[24] The shareholders of the corporation claim their proportionate shares of the tax withheld by the corporation as a credit against their income tax liabilities.[25]

2. *Dividend Credit.*—Under the dividend credit method, shareholders receiving dividends from a corporation claim as a credit against their income tax liabilities their proportionate shares of the income tax paid by the corporation on the corporate net income[26] out of which the dividends are paid.[27] An essential feature of the dividend credit method is the retention of the corporate income tax. A second feature is that shareholders include the credit in gross income.[28]

There are numerous variations of the dividend credit method of

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porate Income Taxes: The Missing Element in Recent Tax Reform Proposals, supra note 1, at 563. This article assumes that any state that adopts integration will conform to the federal treatment of the corporate net income, with minor deviations to account for the state income exemption of interest on federal indebtedness and similar items.

23. BLUEPRINTS, *supra* note 21, at 68-75; Byrne & Sato, *supra* note 1, at 260; Comm. on Corporations of the Tax Section of the N.Y. St. Bar A., *supra* note 1, at 38; STAFF OF JOINT COMM. ON TAXATION, *supra* note 5, at 13; McKessy, *supra* note 7, at 378. Shareholders that are corporations presumably would pay no income tax, but their shares of the corporate net income would be included in their own net incomes and in the gross incomes of their shareholders.

24. Comm. on Corporations of the Tax Section of the N.Y. St. Bar A., *supra* note 1, at 38. Payment of this portion of the corporate net income to the government does not reduce the amount included in the gross incomes of the shareholders. It is designed as a device to alleviate liquidity problems of the shareholders. BLUEPRINTS, *supra* note 21, at 73.

25. *See* note 23 *supra.* Taxes withheld with respect to a shareholder that is a corporation presumably are claimed as credits by the shareholders of that corporation.

26. *See* note 22 *supra.* Several complicated issues must be resolved before the dividend credit method of integration is adopted at the federal level. For example, the credit might be denied for dividends distributed from tax-exempt income. This approach requires tracing the corporate income, an approach not necessarily preferred by the architects of the dividend credit method of integration. *See* Gourevitch, *Corporate Tax Integration: The European Experience,* 31 TAX LAW. 65, 95-96 (1977). Another approach, for example, is to require the corporation to pay tax on all income distributed as dividends. *Id.* at 95.

27. Byrne & Sato, *supra* note 1, at 260; Comm. on Corporations of the Tax Section of the N.Y. St. Bar A., *supra* note 1, at 37-38; STAFF OF JOINT COMM. ON TAXATION, *supra* note 5, at 11; McKessy, *supra* note 7, at 379. The section 116 individual dividend exclusion and section 243 corporate dividends received deduction probably would be repealed.

28. An example of this "gross-up" is as follows. Assume that *A* is a 5% shareholder of Corporation *X*. In 1979, *X* has taxable income of $10,000 and pays corporate income tax of $4,800 (A 48% corporate rate is assumed for purposes of simplicity). *X* distributes a $200 dividend to *A*. *A* must include $385 in gross income—$200 dividend plus $185, the income tax paid by the corporation with respect to the $385 out of which it paid the $200. After computing his income tax liability, *A* claims a $185 credit. *Cf.* I.R.C. § 78, which requires a similar gross-up by corporations that claim the deemed-paid foreign tax credit under sections 902 or 960.

integration. The credit allowed to the shareholder can vary from 100 percent of the tax paid by the corporation to as little as a fraction of a percent of the tax.[29]

3. Dividend Deduction.—Another method of achieving integration is to allow corporations a deduction for dividends paid.[30] This method has no effect on the computation of taxable income by shareholders, although it might include repeal of the dividend exclusion for individuals[31] and the dividends received deduction for shareholders that are corporations.[32]

4. Dividend Exclusion.—Integration can also be accomplished by permitting shareholders to exclude dividends from gross income.[33] This method has a minimal effect on corporations that are shareholders because these corporations presently deduct most dividends from gross income.[34] There is no effect on the corporate income tax.[35]

5. Split Corporate Tax Rates.—The basic premise of the split-rate method of integration is that the corporation pays tax on taxable income that is distributed as dividends at a lower rate than on taxable income that is retained.[36] Countless pairs of split-rates can be adopted,[37] but the important feature of this method is that the basic structures of both corporate[38] and individual income tax remain unchanged.

6. Repeal of Corporate Income Tax.—The final method of integration examined by this article is the repeal of the corporate income tax.[39] Shareholders that are not corporations would continue to include dividends in gross income.[40]

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29. The concepts used in this analysis will not be affected by a change in the credit rate.

30. Comm. on Corporations of the Tax Section of the N.Y. St. Bar A., *supra* note 1, at 38; STAFF OF JOINT COMM. ON TAXATION, *supra* note 5, at 14; McKessy, *supra* note 7, at 380.

31. I.R.C. § 116.

32. *Id.* §§ 243-247.

33. McKessy, *supra* note 7, at 379.

34. *See* note 3 *supra*.

35. To be more precise, there is a slight effect on the corporate income tax because the 85% dividends received deduction under section 243 is converted into a 100% dividend exclusion.

36. Byrne & Sato, *supra* note 1, at 260; STAFF OF JOINT COMM. ON TAXATION, *supra* note 5, at 17.

37. Technically, the dividend deduction method of integration is any form of the split-rate method under which the tax rate on distributed taxable income is zero.

38. The 85% dividends received deduction for corporations under sections 243-247 might be repealed.

39. McKessy, *supra* note 7, at 379.

40. The $100 dividend exclusion for individuals under section 116 might be repealed.

B. Historical Highlights

1. The Split-Rate Experiment of 1936-38.—Corporate and individual income taxes were integrated during only one brief period in the history of the federal income tax. In 1936, Congress imposed a surtax on corporate taxable income that was not distributed as dividends.[41] Taxable income distributed as dividends was taxed at the normal corporate income tax rates.[42] This split-rate method of integration differs from the one previously described because the surtax rates of 1936 varied according to the percentage of taxable income distributed as dividends.[43]

During this period of integration, corporate dividend distributions increased substantially.[44] At the same time, many corporations increased their tax deductible expenditures to avoid the surtax on undistributed taxable income without increasing dividend distributions.[45] In 1938, Congress repealed the surtax on undistributed taxable income.[46]

The effect of split-rate integration on the states during this period is inconclusive. Meaningful statistics are scarce[47] and, in addition, both corporate and individual state income taxes were less significant than they are today.[48] Nevertheless, two principal effects on the state income taxes were notable. First, the increase in dividend distributions increased the income tax bases of the states that had individual income taxes.[49] Second, the increase in corporate expenditures[50] reduced the taxable incomes of corporations subject to state income taxation.[51]

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41. Revenue Act of 1936, ch. 690, § 14, 40 Stat. 1648.
42. *Id.* § 13.
43. *Id.* § 14.
44. STAFF OF JOINT COMM. ON TAXATION, *supra* note 5, at 17.
45. For example, employee compensation and maintenance expenses. *Id.*
46. Revenue Act of 1938, ch. 289, § 27, 52 Stat. 447.
47. The best statistics available are not sufficiently detailed to permit precise analysis.
48. In 1936, state income tax revenues from corporations were $113 million. Revenues from individuals were $153 million. U.S. BUREAU OF CENSUS, HISTORICAL STATISTICS OF THE UNITED STATES 1789-1945, at 317 (1949). In 1978, these amounts were $10.7 billion and $29.1 billion, respectively. U.S. BUREAU OF CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES 292 (101st ed. 1980). Between 1969 and 1979 state tax revenues increased 160%. Revenues from corporate income tax increased 225%. U.S. BUREAU OF CENSUS, GOVERNMENTAL FINANCES in 1978-79, Table 4 (1980); U.S. BUREAU OF CENSUS, GOVERNMENTAL FINANCES in 1969-70, Table 4 (1971). It should be noted that fiscal year 1980 was the eighth consecutive year in which state corporate and individual income tax revenues generated more tax revenue ($50.4 billion) than any other single source. 42 STATE TAX REV. (CCH), No. 10 (March 10, 1981).
49. This occurred whether or not the individual income tax system of the state conformed to the federal system, unless the state excluded dividends from income taxation.
50. *See* text accompanying note 45 *supra*.
51. There may have been secondary effects. For example, the corporate executive who received higher compensation and the business firm that performed maintenance services for the corporation had an increase in income, which in many cases was subject to state income taxation. The principal effects probably offset each other to a great extent.

2. *The Massachusetts Property Tax.*—Little history of corporate-shareholder integration in the United States exists, but the experience of the Commonwealth of Massachusetts with integrated property taxes between 1813 and 1920 offers some interesting insights into the problem. Predictions based on the Massachusetts experience are limited, however, to the possible effects of an integrated system of taxation on state tax administration. Study of the Massachusetts experience is not helpful in determining other possible effects of the various methods of integration on the states.[52]

From the earliest days of its history as a colony and a state, Massachusetts imposed a faculties tax on individuals and corporations.[53] Each individual and corporation was required to submit a general schedule of property that was owned. The schedule included earned and unearned income derived from that property.[54] Since undistributed income of a corporation is reflected in the value of its net assets,[55] the corporation in effect paid a property tax on undistributed income because it paid a property tax on its net assets. At the same time, individual shareholders paid property taxes on the value of stock they owned in the corporation. The value of the stock also reflected the net asset value of the corporation.[56] Under this property tax structure, the undistributed income of the corporation was taxed twice.[57]

The Massachusetts system of taxation was changed in 1813. In a case challenging the double taxation of undistributed income, the Massachusetts Supreme Judicial Court held that a corporation was required to include only real estate in its general schedule of property.[58] This decision had a significant effect on Massachusetts reve-

52. There are issues concerning revenue effects, state legislative decisions to adopt or reject integration, interrelationships among the states, and constitutional problems. For an explanation of why the double taxation eliminated by the integrated property tax differs from the double taxation of corporate income distributed as dividends, see note 57 and accompanying text *infra.*

53. Clarke, *supra* note 7, at 374.

54. *Id.*

55. As a general rule, if a corporation earns income that is not distributed, it either reduces liabilities or increases assets. If it reduces liabilities, its net asset value (assets less liabilities) increases. *See* J. WESTON & E. BRIGHAM, MANAGERIAL FINANCE 89-92 (3d ed. 1969).

56. The stock of a corporation generally increases in value as its net asset value increases. *See id.* at 419-30.

57. *See* Clarke, *supra* note 7, at 374. The effect of the property tax can be more clearly understood if it is assumed that the corporation distributes all its income. Because the net assets of the corporation do not increase, it pays no property tax on the income. The property of the shareholders who receive the dividends increases, assuming that it is not spent on disposable consumer goods. However, the increase in the value of their corporate stock that would occur if the corporate income were not distributed does not occur. The property of the shareholders, and their property tax liabilities, are, as a general proposition, the same as they would be if the corporate income were not distributed. This double taxation differs from that sought to be eliminated under the various income tax integration proposals because it is double taxation of *un*distributed corporate income rather than of distributed corporate income.

58. Salem Iron Co. v. Danvers, 10 Mass. 514 (1813).

nues and its enforcement of the property tax. Shareholders failed to disclose stock ownership,[59] and the stock of nonresident shareholders of Massachusetts corporations was not taxed since the property tax was imposed only on property in Massachusetts.[60] Finally, since the tax was imposed at the local level, manufacturing towns that were required to provide municipal services to corporations were in a less advantageous position than residential towns with smaller municipal burdens.[61]

In 1863, Massachusetts replaced the local property tax system with a corporate property tax that was administered and collected by the state.[62] Finally, in 1916, Massachusetts closed an era in its tax history by enacting a general individual income tax to replace the state property tax system.[63] This article will examine the experience of the Massachusetts tax administrators during this era to determine its significance for recent income tax integration proposals.

C. Current State Treatment of Analogous Situations.

1. Partnerships.—State taxation of partnerships and their partners is especially useful for analyzing the effects of full integration on state income taxation of corporations and their shareholders. The residency of the partner as well as the place where the partnership does business determines the income tax treatment of partners by a particular state. To avoid generalizations that hamper proper analysis, the tax systems of five states will be discussed.

In Illinois, any resident who is a partner in a partnership, regardless of where it does business, must include his distributive share of the net income of the partnership[64] in taxable income.[65] If the resident partner is taxed by another state on all or a portion of his distributive share of the net income of the partnership, the partner can claim a credit for income taxes paid to that state.[66]

A person who is a nonresident of Illinois and a partner in a

59. Clarke, *supra* note 7, at 375.

60. *Id.* at 374.

61. *Id.* at 374-75.

62. *Id.* at 375.

63. 1916 Mass. Acts ch. 289. For an explanation of the reasons for changing to a general income tax, *see generally* Williamson, *Tax Legislation During 1916,* PROC. OF TENTH ANN. CONF. OF NAT'L TAX A. 386, 394-96 (1917). The corporate franchise tax measured by net income was revised in 1919. 1919 Mass. Acts ch. 355.

64. The net income of the partnership is determined as it is for federal income tax purposes. Illinois Income Tax Act § 205(b), ILL. ANN. STAT. ch. 120, § 2-205(b) (Smith-Hurd Supp. 1981-82).

65. Illinois residents compute Illinois taxable income by making certain modifications to their federal adjusted gross incomes. *Id.* §§ 203(a)(1), 301. Technically, the distributive share of partnership net income is included in Illinois taxable income because it is included in Illinois base income, a step in the computation. *See id.*

66. The credit is claimed in accordance with the usual requirements for claiming a credit. These requirements include adequate proof of payment of taxes to the other state, inclusion of the income in Illinois taxable income, and foregoing any deduction for the taxes claimed as a

partnership that earns any income in Illinois must take several steps to determine the amount of income subject to taxation by Illinois. Nonbusiness income of the partnership is allocated to each partner in proportion to his distributive share of the net income of the partnership.[67] Each partner treats the allocated portion as if it were earned in his separate capacity as an individual.[68] Thus, for example, the Illinois taxable income of a nonresident partner includes capital gains from the sale or exchange of real proterty located in Illinois, capital gains from the sale or exchange of personal property having its situs in Illinois, capital gains from the sale or exchange of personal property having its situs in a state that does not tax the gain if the commercial domicile of the partner is in Illinois, and rents from real property located in Illinois.[69] Business income of the partnership is allocated at the partnership level.[70] If the partnership derives its business income solely from Illinois, the entire business income is allocated to Illinois.[71] Otherwise, business income is allocated pursuant to a conventional three-factor formula that measures property, payroll, and sales.[72] The business income attributable to Illinois is then allocated to each partner in proportion to his distributive share of the net income of the partnership.[73]

New York taxes resident partners in virtually the same manner as Illinois taxes resident partners.[74] The New York adjusted gross income[75] of nonresident partners includes the portion of their distributive shares of partnership income that is derived from or connected with New York sources.[76] Partnerships doing business in New York[77] are subject to the unincorporated business tax,[78] which is based on federal adjusted gross income.[79]

Ohio taxes partners in virtually the same manner as Illinois

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credit. *See* Illinois Dep't of Revenue, Instructions to the 1976 Illinois Income Tax Form IL-1040, at 6.

67. ILL. ANN. STAT. ch. 120, § 3-305(b) (Smith-Hurd 1981-82).

68. *Id.*

69. *Id.* § 303, ILL. ANN. STAT. ch. 120, § 3-303 (Smith-Hurd Supp. 1981-82).

70. *Id.* § 305(a).

71. *Id.* § 304(a).

72. *Id.*

73. *Id.* § 305(a).

74. N.Y. TAX LAW ch. 60, §§ 601(b), 617, 620(a) (McKinney Supp. 1979-80).

75. New York adjusted gross income is based on federal adjusted gross income and is the amount from which New York taxable income is computed. *Id.* § 631.

76. *Id.* § 637. The New York treatment of nonresident partners differs from that in Illinois only in the mechanics of allocation and apportionment.

77. Certain other entities, but not corporations, also are subject to the unincorporated business tax. *Id.* § 701(a).

78. The purpose of the unincorporated business tax is to prevent businesses from avoiding the corporate income tax by doing business in an unincorporated form. *See* Moffett v. Bates, 276 App. Div. 38, *aff'd without opinion,* 301 N.Y. 597 (1949).

79. N.Y. TAX LAW ch. 60, § 705(a) (McKinney Supp. 1979-80).

taxes partners.[80] Ohio, however, permits a partnership to file a single return on behalf of, and pay the individual income tax liabilities of, its nonresident partners if those partners derive no taxable income from Ohio other than their distributive shares of the partnership's net income allocable to Ohio.[81]

In Pennsylvania, residents who are partners in any partnership include in their taxable income their distributive shares of each class of income,[82] but not classes of loss,[83] received by the partnership.[84] If all or a portion of the partnership income is subject to income taxation by another state, the partner can claim a credit for the amount of income tax paid to the other state on income included by the partner in taxable income.[85] Nonresident partners of a partnership that derives all its income from sources within Pennsylvania are subject to taxation by Pennsylvania on their entire distributive shares of the net income of the partnership.[86] Otherwise, the nonresident partner is taxed on that portion of the distributive share derived from sources within Pennsylvania plus the Pennsylvania share of income derived from sources not accurately ascertainable.[87]

Although there is no individual income tax in Florida,[88] corporations that are partners include their distributive shares of partnership net income in their Florida taxable income in much the same manner as is done in Ohio and Illinois.[89]

2. *Electing Small Business Corporations.*—State income taxation of electing small business corporations[90] under Subchapter S of the Internal Revenue Code (Subchapter S corporations) illustrates the divergent state legislative reactions to integration of corporation and shareholder[91] taxation at the federal level. For federal income

80. OHIO REV. CODE ANN. §§ 5747.01(A), 5747.05(A), 5747.05(B), 5747.20, 5747.21, 5747.22 (Page 1973 & Supp. 1980).

81. *Id.* § 5747.08(D).

82. The classes of income are compensation, net profits from business, net gains from disposition of property, rents and royalties, dividends, interest, gambling winnings, and net gains or income from estates or trusts. 72 PA. CONS. STAT. ANN. § 7303 (Purdon Supp. 1981-82).

83. Losses are taken into account only to the extent they reduce gains in the same class of income. Net losses in one class of income cannot reduce gains in another class. *Id.*

84. *Id.* § 7306.

85. *Id.* § 7314.

86. *Id.* § 7308.

87. *Id.* § 7310. The results under the Pennsylvania income tax system are not unlike those reached under Ohio and Illinois law, except for the nonrecognition of certain losses as explained in note 83 *supra.*

88. FLA. CONST. art. VII, § 5.

89. FLA. STAT. ANN. §§ 220.02(1), 220.12(1) (West Supp. 1981).

90. *See* I.R.C. §§ 1371-1379.

91. The federal tax treatment of Subchapter S corporations is not precisely full integration. *See* note 19 *supra.* For examples of variations of state legislative reaction to the enactment of Subchapter S in addition to those described in this chapter, see notes 521-31 and accompanying text *infra.*

tax purposes, the shareholders of a Subchapter S corporation, not the corporation, are generally taxable on the net income of the corporation.[92]

In New York,[93] Ohio,[94] and Pennsylvania,[95] Subchapter S corporations are subject to taxation as any other corporations. New York, however, requires resident shareholders of Subchapter S corporations to include their shares of undistributed corporate income in gross income.[96] Nonresidents are not required to do so.[97]

Illinois does not tax Subchapter S corporations.[98] Florida taxes only that portion of Subchapter S corporate income that is subject to federal income tax.[99]

3. Cooperatives.—State income tax treatment of the cooperative also deserves attention.[100] For federal income tax purposes, cooperatives are permitted to deduct amounts paid as capital stock dividends.[101] This treatment of cooperatives is almost identical to the dividend deduction method of integration.[102]

Florida and Illinois specifically permit cooperatives to deduct dividends paid to the same extent that the dividends may be deducted for federal income tax purposes.[103] No specific provisions exist in the tax laws of New York, Ohio, or Pennsylvania dealing with cooperative dividend deductions, but the deduction is presumably allowed because those states define taxable income as federal taxable income and include no modifications of the dividend deductions by cooperatives.[104]

4. Domestic International Sales Corporations.—State income tax treatment of domestic international sales corporations (DISC)[105] demonstrates the reactions of states to partial integration at the fed-

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92. I.R.C. §§ 1371-1379.

93. N.Y. Tax Law ch. 60, § 208(9) (McKinney 1966); Ruling of State Tax Commission, November 17, 1958, 1 N.Y. State Tax Rep. (CCH) ¶ 5-101.375.

94. Ohio Rev. Code Ann. § 5733.01(C) (Page 1973).

95. Letter from Department of Revenue, 106 Pitts. L.J. 52 (1958), 139 Legal Intelligencer 119 (1958), 1 Pa. State Tax Rep. (CCH) ¶ 10-101.70.

96. Opinion of Counsel, November 17, 1967, 1 N.Y. State Tax Rep. (CCH) ¶ 5-101.375.

97. N.Y. Tax Law ch. 60, § 632(b)(4) (McKinney Supp. 1980).

98. Ill. Ann. Stat. ch. 120, § 2-205(c) (Smith-Hurd 1974).

99. Fla. Stat. Ann. § 220.13(2)(i) (West Supp. 1980).

100. I.R.C. § 1381.

101. *Id.* § 1382(c)(1).

102. *See* notes 30-32 and accompanying text *supra.* However, patronage dividends are not deductible. I.R.C. § 1382(b).

103. Fla. Stat. Ann. § 220.13(2)(g) (West Supp. 1980); Ill. Ann. Stat. ch. 120, § 2-203(d)(2)(F) (Smith-Hurd Supp. 1981).

104. N.Y. Tax Law ch. 60, § 208(9) (McKinney 1966 & Supp. 1981); Ohio Rev. Code Ann. § 5733.04(I) (Page 1973); 72 Pa. Cons. Stat. Ann. § 7401(3) (Purdon Supp. 1981).

105. A DISC is defined in I.R.C. § 992(a) as, in effect, a domestic corporation whose receipts and assets are substantially related to export activities.

eral level. A DISC is not subject to federal income tax.[106] Instead, a portion of its net income, whether or not distributed, is included in the income of its shareholders.[107] The remainder of the net income is effectively untaxed.[108] For this reason, the federal income tax treatment of a DISC is not full integration. Nevertheless, taxation of DISCs sufficiently resembles full integration and is therefore relevant for analysis.

In Pennsylvania, a DISC is taxed in the same manner as other corporations.[109] A DISC shareholder who is an individual and a resident of Pennsylvania is required to include in gross income all dividends actually received from the DISC.[110] The nonresident individual shareholder of a DISC is not subject to Pennsylvania taxation on dividends actually received from the DISC.[111] A shareholder of a DISC that is a corporation subject to tax by Pennsylvania includes its share of the net income of the DISC in Pennsylvania gross income.[112] The corporation, however, is permitted to deduct "dividends received from any other corporation but only to the extent that such dividends are included in [federal] taxable income."[113] Presumably, although dividends deemed distributed to a shareholder of a DISC for federal income tax purposes are not "received" by the shareholder, the corporate shareholder of the DISC is permitted to deduct its share of DISC income included in federal and, thus, Pennsylvania income.

In Ohio, the DISC is also subject to taxation in the same manner as other corporations.[114] The shareholder of the DISC includes in Ohio taxable income that portion of the DISC's federal taxable income allocable to Ohio, based on the assets of the DISC situate in Ohio and elsewhere.[115]

In Florida,[116] Illinois,[117] and New York,[118] the DISC is exempt

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106. I.R.C. § 991.

107. *Id.* § 995. The calculation of the portion of the net income of the DISC that is included in the gross income of its shareholders is very complicated, but as a general rule it can be as little as one-half, or as great as all of the net income of the DISC.

108. *Id.* The income that is not taxed may be taxed in the future when and if the shareholder disposes of stock in the DISC, or when and if the DISC terminates existence as a DISC or is disqualified as a DISC. *Id.* § 995(b)(2), (c).

109. Letter from Director, Bureau of Corporation Taxes, to Commerce Clearing House, Inc. (May 30, 1972), 1 PA. STATE TAX REP. (CCH) ¶ 10-101.10.

110. 72 PA. CONS. STAT. ANN. § 7303(a)(5) (Purdon Supp. 1981).

111. *Id.* §§ 7302(b), 7308. *See* Pa. Dep't of Revenue, 1977 Pennsylvania Individual Income Tax Forms and Instructions at 11.

112. 72 PA. CONS. STAT. ANN. § 7401(3) (Purdon Supp. 1981).

113. *Id.* *See* note 127 and accompanying text *infra* for the interpretation given to this language with respect to Subpart F income. The same reasoning should apply by analogy to deemed dividends from a DISC.

114. OHIO REV. CODE ANN. § 5733.01(D) (Page 1973).

115. Tax Commissioner's Special Instruction No. 12 (September 5, 1972), 1 OHIO STATE TAX REP. (CCH) ¶ 10-305.30.

116. Since Florida taxable income is based on federal taxable income, a DISC has no Florida taxable income. *See* FLA. STAT. ANN. § 220.12(1) (West Supp. 1981).

117. Illinois taxable income also is based on federal taxable income. ILL. ANN. STAT. ch. 120, § 2-203(b)(1) (Smith-Hurd Supp. 1981).

118. N.Y. TAX LAW ch. 60, § 208(9)(i) (McKinney Supp. 1980).

from taxation. In Florida, individual shareholders of a DISC are not subject to income tax.[119] Individual shareholders in Illinois and New York and corporate shareholders in all three states are taxed on the properly allocable portion of the DISC's federal taxable income.[120] In New York, any corporation subject to New York taxation that is a shareholder in a DISC must file a consolidated income tax return with the DISC.[121]

5. *Controlled Foreign Corporations.*—For purposes of analyzing state legislative reaction to federal income tax provisions resembling integration, controlled foreign corporations (CFC)[122] are treated similar to DISCs for federal income tax purposes.[123] Generally, shareholders[124] include a portion of the net income of the CFC in federal taxable income (Subpart F income); the remainder of the net income is, in effect, deferred for tax purposes.[125]

Florida and Ohio specifically exclude Subpart F income from taxable income.[126] In Pennsylvania, Subpart F income is excluded pursuant to *Commonwealth v. Emhart Corp.*[127] Subpart F income is included in Illinois and New York taxable income.[128] Both states provide, however, that foreign taxes on Subpart F income, which shareholders of CFCs must include in federal taxable income if they claim a foreign tax credit[129] for federal taxes,[130] are excluded from taxable income.[131] The CFC itself is taxed by a state if it does business in the state and derives income from that activity.[132]

119. *See* note 88 and accompanying text *supra*.

120. *See* FLA. STAT. ANN. § 220.12(1) (West Supp. 1981); ILL. ANN. STAT. ch. 120, §§ 2-203(b)(1), 3-301 (Smith-Hurd 1974 & Supp. 1981); N.Y. TAX LAW ch. 60, § 208(8-A) (b) (McKinney Supp. 1980).

121. N.Y. TAX LAW ch. 60, § 208(9)(i)(B) (McKinney Supp. 1980); N.Y. TAX REG. § 3-9-.3(b), 1 N.Y. STATE TAX REP. (CCH) ¶ 9-626.

122. Controlled foreign corporations are defined in I.R.C. § 957 as, in effect, a foreign corporation of which more than 50% of its shareholders are United States persons.

123. I.R.C. §§ 951-964. In contrast to a DISC, the CFC, and not its shareholders, is subject to tax on any income from sources within the United States that is effectively connected with trade or business in the United States. *Id.* §§ 882, 952(b).

124. This does not include foreign shareholders not subject to taxation by the United States. *Id.* §§ 951(b), 957(d).

125. *See id.* §§ 882, 951. *See also* note 108 *supra*; I.R.C. §§ 367, 1248.

126. FLA. STAT. ANN. § 220.13(3)(b)(2) (West Supp. 1981); OHIO REV. CODE ANN. § 5733.04(I)(2) (Page 1973).

127. 443 Pa. 397, 278 A.2d 916 (1971), *appeal dismissed, cert. denied,* 404 U.S. 981 (1972). *See* notes 109-13 and accompanying text *supra*.

128. *See* note 117 *supra*. The law in New York is similar to the law in Illinois on this issue. N.Y. TAX LAW ch. 60, § 208(9) (McKinney 1966 & Supp. 1980).

129. I.R.C. §§ 901, 902, 960.

130. *Id.* § 78. *See* note 28 and accompanying text *supra*.

131. ILL. ANN. STAT. ch. 120, § 2-203(b)(2) (Smith-Hurd Supp. 1981); N.Y. TAX LAW ch. 60, § 208(9)(a)(6) (McKinney Supp. 1980).

132. Since the net income of a corporation, for purposes of the income tax laws of the five states discussed in this section, is based on federal taxable income, the income from that busi-

6. Corporations Formed to Avoid Income Tax on Shareholders.—Certain federal income tax provisions remotely resemble integration because they require corporations, or shareholders under certain conditions, to pay tax on certain undistributed taxable income.[133] These provisions address the accumulated earnings tax,[134] personal holding companies,[135] and foreign personal holding companies.[136] The corporation is permitted to deduct dividends paid to shareholders when it computes the amount on which the accumulated earnings or personal holding company tax is imposed.[137] The deduction for dividends paid is taken into account[138] in computing the foreign personal holding company income required to be included in the gross income of the shareholders.[139]

The five state tax laws discussed in this section do not contain provisions comparable to those in the federal tax law.[140] Because the accumulated earnings tax and personal holding company tax are not taxes on taxable income under section 11 of the Internal Revenue Code,[141] the amounts subject to those taxes are not included in the taxable income of corporations, whether or not based on federal taxable income. In Pennsylvania, individuals do not include foreign personal holding company income in gross income because no provision includes that income in one of the classes of income.[142] Corporations in Pennsylvania can deduct the foreign personal holding company income from taxable income[143] because that income is a dividend to them.[144] The statutes of the other three states analyzed in this section contain no provisions that exclude foreign personal holding company income from the taxable income of individuals based on federal taxable income.[145]

D. *Analogous Foreign Situations*

1. Canada.—A proposed but unadopted method of integrating corporate and individual income taxes in Canada provides insights into the problems that might be raised by integration in the United

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ness activity generally is subject to federal and, thus, state income tax only if it is effectively connected with the conduct of a trade or business in the United States. *See* I.R.C. § 882.

133. I.R.C. §§ 531-565.

134. *Id.* §§ 531-537.

135. *Id.* §§ 541-547.

136. *Id.* §§ 551-558.

137. *Id.* §§ 535(a), 545(a), 561-565.

138. To this extent, the foreign personal holding company provisions more closely resemble integration than do the accumulated earnings and personal holding company provisions.

139. I.R.C. § 556(a).

140. *See, e.g.,* 1 ILL. STATE TAX REP. (CCH) ¶ 11-701.

141. I.R.C. §§ 531, 541(a).

142. *See* 72 PA. CONS. STAT. ANN. § 7303 (Purdon Supp. 1981).

143. *Id.* § 7401(3).

144. *See* I.R.C. § 551(b); notes 109-13 and accompanying text *supra.*

145. *See* note 140 and accompanying text *supra.*

States. The relationship between the provinces and the national government of Canada is similar to the relationship between the various states and the federal government in the United States.

In 1966, the Royal Commission on Taxation (Carter Commission) proposed the integration of corporate and individual income taxes.[146] Under the proposal, the corporation pays tax on its income[147] and shareholders include in income their share of the net income of the corporation, whether or not distributed.[148] The tax paid by the corporation on the share of the corporate income that is included in the income of the shareholder is added to the income of the shareholder. The shareholder then claims that tax as a credit.[149] The Ministry of Finance, which presented the proposal to the Parliament,[150] supported the proposal only as applied to closely held corporations. A modified proposal was reported favorably by the House of Commons Standing Committee on Finance, Trade and Economic Affairs.[151] The Parliament, however, did not adopt the proposal[152] because of the impact of integration on the Canadian national economy.[153]

One of the reasons that the Carter Commission integration proposal was rejected concerns the anticipated impact of integration on the provinces.[154] According to the Carter Commission, an integration program that lacked coordination between the federal government and the provinces would be "unsatisfactory" and an "administrative nightmare."[155] Nonetheless, the Commission proposed integration, and recommended only four methods to prevent the problems that integration would pose to the provinces. First, the Commission suggested that provinces not already participating should permit the federal government to collect income taxes on behalf of the provinces,[156] as the "piggyback" provisions of the Internal

146. Royal Commission on Taxation, 4 Report 7 (Ottawa 1966).

147. *Id.*

148. *Id.*

149. *Id.* The proposal was a combination of full integration and a dividend credit method of integration that can properly be labelled a distributive share credit method of integration.

150. E. Benson (Minister of Finance), Proposals for Tax Reform §§ 4.20, 4.34 (1969).

151. House of Commons Standing Comm. on Finance, Trade and Economic Affairs, 28th Parl., 2d Sess., Report Respecting the White Paper on Tax Reform 42 (Comm. Print 1970).

152. *See* the discussion in Gourevitch, *supra* note 26, at 84-86.

153. Some of the reasons included a shift in the tax burden from the corporate income tax to other taxes, the ignoring of the separate existence of corporations, and the creation of a rigid federal tax system. *See id.* at 85-86; Hammer, *The Taxation of Income from Corporate Shareholding: Review of Present Systems in Canada, France, Germany, Japan and the U.K.*, 28 NAT'L TAX J. 315, 324-27 (1975).

154. *See* Standing Senate Comm. on Banking, Trade and Commerce, 28th Parl., 2d Sess., Report on the White Paper Proposals for Tax Reform Presented to the Senate of Canada 45 (Comm. Print 1970).

155. Royal Commission on Taxation, 6 Report 197 (Ottawa 1966).

156. *Id.* at 195.

Revenue Code[157] permit the United States to collect individual income taxes on behalf of qualifying states.[158] Second, the Commission recommended that the provinces forego taxing corporations.[159] Alternatively, it suggested that the federal government permit shareholders to take a credit against their federal tax liabilities for both the federal tax on the corporation and a standard rate of provincial corporation tax.[160] Finally, the Commission recommended a highly technical harmonization of corporate and individual federal and provincial income tax rates and a continuation of the federal allowance for abatement of individual provincial income taxes.[161]

The Ministry of Finance modified in three respects the recommendations of the Carter Commission concerning the impact of integration on the provinces. First, the Ministry proposed extensive discussions on the matter between the federal government and the provinces.[162] Second, it stated that changes in the provincial tax law would be required.[163] Finally, it proposed the repeal of the federal allowance for abatement of individual provincial income taxes.[164] The Standing Senate Committee on Banking, Trade, and Commerce reported that the provinces had "expressed their disagreement with the introduction of" a "radical and complicated restructuring of the tax system."[165] The Committee stated that if several provinces refused to harmonize their income tax systems with that of the federal government, the result would be an "impenetrable jungle of tax law that would defy rational application."[166]

2. *West Germany.*—West Germany is the only nation with an integrated corporate and individual income tax and a federal relationship between the states and the national government. The struc-

157. I.R.C. §§ 6361-6365.

158. Both the United States and Canadian federal "piggyback" provisions require that the state or provincial income tax conform substantially to the federal income tax. *Id.* § 6361(a); Federal-Provincial Fiscal Arrangements Act, 1960-61 CAN. STAT. ch. 58; Federal-Provincial Fiscal Arrangements and Established Programs Financing Act, 1976-77 CAN. STAT. ch. 10, § 7 (1977).

159. Royal Commission on Taxation, 6 Report 195 (Ottawa 1966).

160. *Id.* at 197. It should be pointed out that this suggestion may have been made in light of the fact that only two provinces at that time had not agreed to piggyback collection of their taxes by the federal government. *Id.* at 190.

161. *Id.* at 199.

162. E. Benson, *supra* note 150, at § 7.10.

163. *Id.* § 7.11.

164. *Id.* § 7.12. The House of Commons Standing Committee on Finance, Trade and Economic Affairs merely stressed the importance of coordination between the federal government and the provinces. House of Commons Standing Comm. on Finance, Trade and Economics, *supra* note 151, at 45.

165. Standing Senate Comm. on Banking, Trade and Commerce, *supra* note 154, at 45.

166. *Id.* If this prediction is applicable to the United States, it casts a dark cloud on the future of income tax integration. In subsequent sections, this article explores whether the fears of the Senate of Canada have meaning for the United States.

ture of income taxation in West Germany, however, makes analogy to the United States and its individual states difficult.

Prior to 1977, West Germany had a split-rate method of integration[167] that taxed undistributed corporate net income at fifty-one percent and distributed income at fifteen percent.[168] Since 1976, West Germany has had a combination split-rate and dividend credit method of integration. Undistributed corporate income is taxed at fifty-six percent and distributed income is taxed at thirty-six percent.[169] Shareholders, however, are permitted to claim a credit for the taxes paid by the corporation on the income distributed to them.[170] The tax claimed as a credit must be included in the income of the shareholder.[171]

The states of West Germany have a unique relationship with the federal government in the area of income taxation. The states do not have separate legislative powers to tax, but share the proceeds of the basic corporate[172] and individual taxes[173] with the federal government and municipalities.

Determination of the respective shares of the federal, state, and municipal governments requires the consent of the Council of States.[174] Special formulas allocate the share of the states among the states, and equalization procedures take into account the different financial strengths of the various states.[175] Because of this mechanism, which resembles revenue-sharing, income tax integration has not created any significant problems for the states of West Germany.

III. The State in Isolation: The Effect of Income Tax Integration

A. *Introduction*

Congressional integration of corporate and individual income taxes will produce an immediate effect on the various states in the absence of state legislative reaction. The extent of that immediate effect depends on the method of integration adopted and the nature of each particular state's system of taxation.[176] This section exam-

167. Hammer, *supra* note 153, at 317-18. For a description of the split-rate method of integration, *see* notes 36-38 and accompanying text *supra*.

168. *See* Gourevitch, *supra* note 26, at 68-69; Hammer, *supra* note 153, at 317-18.

169. *Id.*

170. *Id.*

171. *Id.*

172. HARVARD LAW SCHOOL, WORLD TAX SERIES: TAXATION IN THE FEDERAL REPUBLIC OF GERMANY, ch. 1, § 3.2 (2d ed. H.J. Gumpel 1973).

173. There is a corporate income tax on undistributed net income. *See* note 169 and accompanying text *supra*.

174. HARVARD LAW SCHOOL, *supra* note 172, at § 3.2.

175. *Id.*

176. The nature of state taxing systems can be analyzed in terms of their conformity to the federal income tax. Under this approach, states can be separated into the following six categories: (1) states with no income tax; (2) states with no individual income tax, but with a corpo-

ines various situations that might arise and develops an analysis of the immediate effects on the states.[177] Two assumptions underlie the analysis for each state: (1) the corporation is incorporated and does all its business in that state[178] and (2) the shareholders of that corporation are residents[179] of that state.[180]

B. Full Integration

States that require corporations to compute state taxable income by making adjustments to federal taxable income[181] will be signifi-

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rate income tax that confronts to the federal income tax; (3) states with an individual and corporate income tax, neither of which conform to the federal income tax; (4) states with an individual and corporate income tax, of which only the individual income tax conforms to the federal income tax; (5) states with an individual and corporate income tax, of which only the corporate income tax conforms to the federal income tax; and (6) states with an individual and corporate income tax, both of which conform to the federal income tax.

This article focuses primarily on states in the second, fifth, and sixth categories. Of the states in the first category, the adoption of income tax integration at the federal level will have no effect other than to change income taxes that residents pay to other states from sources within which they earn income. With respect to states in the third category, the effect is the same as it is for states in the first category except that the state might review its decision not to conform to the federal income tax. The analysis of the effect on states in the fourth category is inversely analogous to the fifth category.

177. The next section discusses what reactions, if any, various state legislatures might take in response to the enactment of income tax integration by the Congress. *See* notes 230-329 and accompanying text *infra*. Subsequent sections embellish the analyses in this and the next section by taking into account the federal relationship among the states. *See* notes 330-502 and accompanying tex *infra*.

178. The purpose of this assumption is to prevent the hypothetical corporation discussed in this section from being subject to income taxation by any other state. This permits the analysis to begin at a less complex stage than it does in the subsequent sections in which it is assumed at times that the corporation is subject to taxation by more than one state. *See* notes 357-502 and accompanying text *infra.* The term "resident" when used in this article with respect to corporations means a corporation subject to income taxation by the state in which it is a "resident."

179. States have different definitions of "resident." For example, Pennsylvania defines resident as "an individual who is domiciled in [Pennsylvania] unless he maintains no permanent place of abode in [Pennsylvania] and does maintain a permanent place of abode elsewhere . . . or who is not domiciled in [Pennsylvania] but maintains a permanent place of abode in [Pennsylvania]." 72 PA. CONS. STAT. ANN. § 7301(p) (Purdon Supp. 1977). In contrast, Ohio defines resident as "[a]n individual who is domiciled in [Ohio and an] individual who . . . maintains a permanent place of abode in [Ohio], and who does not maintain a permanent place of abode elsewhere." OHIO REV. CODE ANN. § 5747.01(I)(1), (2) (Page Supp. 1975). The term "resident" when used in this article with respect to individuals includes the various concepts associated with the definition but it is assumed that in no event is an individual a resident of more than one state. This permits initial analysis to begin at a more fundamental stage. *See* note 178 *supra.* In subsequent sections, portions of the analysis assume that an individual is subject to taxation by more than one state, as a resident of one state and a nonresident of another.

180. More complex situations, in which the corporation, the shareholder, or both, are subject to taxation in more than one state, are analyzed in subsequent sections of this article. *See* notes 330-502 and accompanying text *infra.*

181. The corporate income tax systems of the five states whose income tax systems are examined in this section conform to the federal income tax system. As of December 16, 1980, thirty-five of the forty-six states with corporate income taxes did likewise. 41 STATE TAX REV. (CCH) No. 51, at 4-5 (December 16, 1980). In a few of these states, however, the conformity is with respect to the Internal Revenue Code as of a specific date. *See, e.g.,* Wallace v. Commissioner of Taxation, 289 Minn. 220, 184 N.W.2d 588 (1971) (Minnesota Constitution prohibits federal amendments to Internal Revenue Code subsequent to date referentially adopted by legislature from being applicable to Minnesota). This article assumes that state conformity to

cantly affected by adoption of full integration at the federal level.[182] Under full integration, federal taxable income of corporations is zero.[183] Accordingly, the state taxable income of the corporation is zero unless the corporation has items of income excluded from its federal gross income or has taken deductions on its federal return for which there are adjustments required by the state tax law.[184] For example, a corporation must add municipal bond interest, state income taxes paid or accrued, and one-half of net long-term capital gain to federal taxable income.[185] These adjustments, however, not only offset each other to some extent,[186] but also constitute a relatively minor fraction of state taxable income of corporations.[187] Consequently, states will experience a drastic decrease in corporate income tax revenues.[188]

Full integration at the federal level will have various effects on state individual income taxation. In Pennsylvania, there will be no effect[189] because individual taxable income is computed without re-

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the federal income tax base is so structured that amendments to the federal tax law are automatically adopted by the state.

182. The unincorporated business tax law in New York also is affected. *See* notes 78-79 and accompanying text *supra*.

183. *See* notes 21-23 and accompanying text *supra*. The corporation has a tax liability if it is required to withhold taxes on behalf of the shareholders. This is the liability of a withholding agent, however, not income tax liability. *See* notes 24-25 and accompanying text *supra*.

184. Most state corporate income tax laws contain at least several of these items. *See* note 185 and accompanying text *infra*.

185. *See, e.g.,* ILL. ANN. STAT. ch. 120, § 2-203(a)(2) (Smith-Hurd Supp. 1981). The language of the Illinois statute raises an interesting issue. The adjustments are required "to the extent excluded [or deducted] from gross income in the computation of adjusted gross income." *Id.* Initially, it might be argued that the adjustments required by the statute do not exist because under full integration corporations do not compute adjusted gross income or gross income. It is more likely, however, that under full integration corporations will continue to compute gross and taxable incomes, in order to compute the distributive shares of corporate net income included in the gross income of the shareholders. The mechanics probably will not be unlike the partnership provisions of Subchapter K of Chapter 1 of the Internal Revenue Code. *See, e.g.,* I.R.C. §§ 701-703.

186. There are subtraction adjustments as well as the addition adjustments, some of which are listed in the text accompanying note 185 *supra*. *See, e.g.,* ILL. ANN. STAT. ch. 120, § 2-203(a)(2) (Smith-Hurd Supp. 1981).

187. Complete and precise statistics are difficult to find, but it is possible to approximate the situation. In 1977, the income of corporations subject to federal income tax was $212.5 billion. The amount of one important subtraction, interest from state and local obligations, was only $8.3 billion. U.S. DEP'T OF THE TREASURY, I.R.S., PRELIMINARY STATISTICS OF INCOME—1977 CORPORATION INCOME TAX RETURNS, Pub. 159, at 3, 13 (1981) [hereinafter cited as IRS 1977 CORPORATION INCOME TAX STATISTICS].

188. In 1979, the states raised $12.1 billion from corporate income tax revenues. Of that amount, $8.3 billion was raised by states whose corporate income tax systems conformed to the federal income tax system. U.S. BUREAU OF CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES 305 (101st ed. 1980).

189. Pennsylvania requires individuals to include "dividends" in taxable income. 72 PA. CONS. STAT. ANN. § 7303(a)(5) (Purdon Supp. 1981). The term "dividends", however, should not encompass undistributed taxable income of a corporation included in the federal gross income of the shareholder because the term will continue to have independent significance. This conclusion is based on analogy to the partnership provisions of Subchapter K of Chapter 1 of the Internal Revenue Code, in which distributions are distinguished from distributive shares. *See, e.g.,* I.R.C. § 736(b)(1).

gard to federal taxable income.[190] A significant effect, however, will occur in states whose individual income tax base conforms to the federal income tax base.[191] Since there are no provisions in the tax laws of these states permitting the shareholder to deduct undistributed taxable income of the corporation from taxable income for purposes of computing state taxable income, revenues from individual income taxes in those states will increase.[192]

The combined effect of full integration at the federal level on corporate and individual income taxes of the state varies according to the facts and circumstances of each case.[193] In Florida, where there is no individual income tax, the combined effect will be an almost complete elimination of income tax revenues.[194] Similarly, in Pennsylvania, where individual income tax revenues will be essentially uneffected, corporate income tax revenues will be virtually eliminated.[195] Whether the combined effect will produce an increase or decrease in state income tax revenues in the other states—Illinois, Ohio, and New York—depends on the interplay of three factors. First, the actual effect is contingent upon whether the average corporate income tax rate is higher or lower than the average individual income tax rate.[196] For example, in Illinois corporations pay tax at a flat rate of four percent of taxable income and individuals pay tax at a flat rate of two and one-half percent.[197] Second, the corporate dividend rate[198] is of consequence because it affects the amount of cor-

190. *See* 72 PA. CONS. STAT. ANN. §§ 7302, 7303 (Purdon Supp. 1981).

191. The conformity can be a reference to federal taxable income, a reference to federal adjusted gross income, or by reference to federal income tax liability. As of December 16, 1980, thirty-three of the forty-four states with individual income taxes had individual income tax systems that conformed to the federal income tax system. 41 STATE TAX REV. (CCH) No. 51, at 6 (December 16, 1980). The analysis of this article generally is not affected by the manner in which the state attains conformity to the federal income tax system. If in a particular case the manner of conformity is of significance, the author so indicates.

192. In 1979, the states raised $32.6 billion from individual income tax revenues. Of that amount, $23.9 billion was raised by states whose individual income tax systems conformed to the federal income tax system. U.S. BUREAU OF CENSUS, STATISTICAL ABSTRACT OF THE UNITED STATES 305 (101st ed. 1980). In states that require income tax liability to be computed as a percentage of federal income tax liability, the same result is reached because there is a higher federal income tax liability on which to base state income tax liability.

193. These conclusions are based on an assumption that there are no interstate aspects to each transaction. *See* notes 178-80 and accompanying text *supra*. The complications raised by considering these interstate aspects are discussed in subsequent sections of this article. *See* notes 330-502 and accompanying text *infra*.

194. *See* notes 213-15 and accompanying text *infra*.

195. Unlike Florida, Pennsylvania will not lose virtually *all* its income tax revenues. It is doubtful, however, whether that distinction would make the tax administrators of Pennsylvania less concerned than those of Florida.

196. The existence of progressive tax rate structures at the state level and the difficulty in determining tax brackets of shareholders makes it extremely difficult to derive a more precise estimate.

197. ILL. ANN. STAT. ch. 120, § 2-201(b) (Smith-Hurd 1974). The flat rates are required by the Illinois Constitution. ILL. CONST. art. IX, § 3(a).

198. The dividend rate is the percentage of corporate income after taxes distributed as dividends.

porate income subject to double taxation at the state level.[199] Finally, the result is affected by the provision in most state tax laws disallowing state income taxes as deductions in computing corporate net income for state tax purposes[200] and by the state tax treatment of federal income taxes.[201]

C. *Dividend Credit*

The adoption of a dividend credit method of integration at the federal level will affect state revenues from the corporate income tax only slightly. Under the dividend credit method, corporations continue to pay federal income tax. Thus, no change will result in the federal corporate taxable income on which most states base corporate net income for purposes of their income tax law. If the corporation receives a dividend from another corporation, however, the corporation will be required to include in taxable income for state purposes the federal income tax paid by the payor of the dividend that is attributable to the dividend.[202] In the states whose corporate income tax base conforms to the federal income tax base, however, no provisions permit the recipient of a dividend to deduct the federal income tax attributable to the dividend from taxable income.[203] In

199. *See* the illustrations in Appendix I *infra.* Except for rate changes and the time value of money, the long-run effect on state income tax revenues is not affected by the corporate dividend rate because corporate earnings are distributed as dividends, distributed on termination of the corporation, or realized as income when a shareholder sells stock. This assumes that the state taxes the gain on the sale as it taxes other income, which most states do. *See, e.g.,* 72 PA. CONS. STAT. ANN. § 7303(a)(3) (Purdon Supp. 1981). However, it is important to the state to ascertain the effect in a particular year of income tax integration at the federal level on its income tax system. Thus, the short run effects of the corporate dividend rate are quite relevant.

200. ILL. ANN. STAT. ch. 120, § 2-203(b)(2)(B) (Smith-Hurd Supp. 1981); N.Y. TAX LAW ch. 60, § 208(9)(b)(4) (McKinney Supp. 1980). This type of provision creates an interesting problem if none of the adjustment described in notes 184-85 and accompanying text *supra* apply, other than the add-back of state income tax deducted in computing federal taxable income. The state income tax cannot be computed until the state taxable income is computed. Since the state taxable income consists solely of the state income tax, however, the state income tax cannot be computed until the state income tax is computed. If any other state adjustments are made to federal taxable income, the problem can be algebraically resolved. Otherwise the state income tax must be zero.

201. Illinois, New York, and Ohio do not permit the deduction of federal income taxes in computing corporate or individual taxable income. *See* 41 STATE TAX REV. (CCH) No. 51, at 4, 6 (December 16, 1980). Six states, however, permit corporations to deduct federal income taxes in computing taxable income, and seventeen states permit individuals to do likewise, usually subject to limitations. *Id.* The analysis in this article is based on the Illinois approach. To this extent, modifications in the analysis must be made for those states with the opposite approach.

The difficulty in determining the immediate effect of full integration on the income tax systems of states similar to Ohio, Illinois, and New York is demonstrated by illustrations in Appendix I *infra*.

202. *See* FLA. STAT. ANN. § 220.12(1) (West Supp. 1981); ILL. ANN. STAT. ch. 120, § 2-203(b)(1) (Smith-Hurd Supp. 1981); N.Y. TAX LAW ch. 60, § 208(9) (McKinney 1966 & Supp. 1981); OHIO REV. CODE ANN. § 5733.04(I) (Page 1973); 72 PA. CONS. STAT. ANN. § 7401(3) (Purdon Supp. 1981).

203. If the new federal provisions requiring a recipient of a dividend to include all or a portion of the federal corporate income tax attributable to the dividend in gross income are

these states, therefore, income tax revenues from corporations that receive dividends will increase slightly.[204]

The effect of the dividend credit method of integration at the federal level on state individual income taxation varies. In Pennsylvania, no effect will occur since individual taxable income is computed without regard to federal taxable income. Florida will also be unaffected since no individual income tax exists in that state. Similarly, in states where the individual income tax base conforms to the federal income tax base[205] no noticeable effect will result. Individuals receiving dividends will be required to include in taxable income for state purposes the federal income tax paid by the corporation that is attributable to the dividend.[206] Because the tax laws of these states do not contain provisions permitting the recipient of a dividend to deduct the federal income tax attributable to the dividend from taxable income,[207] the revenue that these states receive from individual income taxes will increase to some extent.[208]

The combined effect of a federal dividend credit method of integration on the corporate and individual income taxes of the states varies according to the particular tax system of each state.[209] In

placed in section 78 of the Internal Revenue Code, the conclusion in the text would need to be changed. In this case, there would be no effect in those states whose income tax laws presently exclude the section 78 "gross-up" from state taxable income. *See* notes 129-31 and accompanying text *supra*. It is probable that new federal provisions would not be inserted in section 78.

204. *See* note 192 *supra*. In 1977, domestic corporations paid $61.5 billion in dividends, of which $13.9 billion were paid to other domestic corporations. IRS 1977 CORPORATION INCOME TAX STATISTICS, *supra* note 187, at 13. Of course, if the federal dividend credit provisions do not permit recipients of dividends corporations to claim the credit, there would be no effect on state corporate income tax revenues.

205. *See* note 191 and accompanying text *supra*. If the state bases its individual income tax liability on a percentage of federal individual income tax liability after credits, the effect of integration on the state revenues is compounded.

206. *See* ILL. ANN. STAT. ch. 120, § 2-203(a) (Smith-Hurd Supp. 1977); N.Y. TAX LAW ch. 60, § 612 (McKinney Supp. 1981); OHIO REV. CODE ANN., § 5747.01(S) (Page Supp. 1975).

207. *See* notes 203-04 and accompanying text *supra*. Likewise, there are no provisions in the income tax laws of these states permitting the shareholder to claim a credit for the federal income taxes paid by the corporation.

208. *See* note 192 and accompanying text *supra*. In 1974, individuals listing Illinois as their state of residence for federal tax purposes reported $1.7 billion in dividends, after the dividend exclusion of section 116 of the Internal Revenue Code was applied. This statistic is approximate for purposes of estimating the Illinois revenue effect because there may be a few of those individuals whose residences for state tax purposes were not in Illinois, and there also were some part-year Illinois residents. The statistic is, however, sufficiently approximate that the impact of the dividend credit method of integration on Illinois revenues is evident. For Ohio and New York, the amounts were $1.2 billion and $3.47 billion, respectively. U.S. DEP'T OF THE TREASURY, I.R.S., PRELIMINARY STATISTICS OF INCOME—1978 INDIVIDUAL INCOME TAX RETURNS, Pub. 198, at 49-50 (1980).

To estimate the amount of federal income tax attributable to those dividends that would be included in state taxable income, these amounts must be multiplied by 48/52, the reciprocal inverse of the approximate dividend to corporate federal income tax ratio. Thus, shareholders in Illinois, Ohio, and New York would include approximately $1.57 billion, $1.1 billion, and $3.2 billion in state individual taxable income, respectively.

209. *See* note 193 *supra*. If no dividends are distributed in the state, no effect on state income tax revenues will occur. *See* Appendix I *infra*. This highly theoretical possibility is pursued no further in this article.

Florida and Pennsylvania, where no effect will occur at the individual income tax level, an increase in state income tax revenues will depend on the relative proportion of shareholders that are corporations and on the corporate dividend rate.[210] In the other states—Illinois, Ohio, and New York—the result will be an increase in revenue from corporate and individual income taxes. The extent of the increase depends on two factors. First, the corporate dividend rate is relevant for the same reason it is a factor in determining the immediate effect of full integration on state income tax revenues.[211] Second, the relative proportion of shareholders that are corporations and the average corporate income tax rate in comparison to the average individual income tax rate are important factors because they determine the level at which the federal income tax paid by the payor of the dividend will be subject to state income tax.[212]

D. *Dividend Deduction*

States that require corporations to compute state taxable income by making adjustments to federal taxable income will be affected by adoption of a dividend deduction method of integration at the federal level. Under the dividend deduction method of integration, federal taxable income of corporations is reduced to the extent of dividends paid.[213] Accordingly, state taxable income of the corporations is reduced and there will be a decrease in state corporate income tax revenues.[214]

The dividend deduction method of integration has no effect on state individual income tax revenues. Florida has no individual income tax. Pennsylvania calculates individual income without regard to the federal system. Illinois, Ohio, and New York are not affected

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210. *See* note 198 and accompanying text *supra.*

211. *See* notes 198-99, 201 and accompanying text *supra.*

212. For example, assume that Corporation *X* distributes a $1,000 dividend to its shareholders. Further assume that the federal income tax paid by *X* with respect to that $1,000 is $923. To pay a dividend of $1,000 when the federal corporate income tax rate is 48%, *X* must earn $1,923 ($1,000 divided by .52, the correlative of .48). If the shareholders of *X* are corporations whose average state income tax rate is 5%, state income tax revenues increase by $46.15 ($923 × .05). If the shareholders of *X* are individuals whose average state income tax rate is 3%, state income tax revenues increased by $27.69 ($923 x .03).

If some or all of the shareholders were corporations, the numbers in the example would change, but the principle would remain unchanged. *See* note 201 *supra* and Appendix I *infra*. The result in this example differs from that with respect to full integration because, unlike the case of full integration, the corporation pays state income tax. The importance of the corporate dividend rate is demonstrated by illustrations in Appendix II *infra*.

213. *See* note 30 and accompanying text *supra*. If no corporations pay dividends, which is an extreme case, there would be no effect. This possibility is pursued no further in this article. At the other extreme is maximum dividend payout. The effect on state corporate income tax revenues in that case resembles full integration. *See* note 200 *supra.* The problem described in note 200 *supra* with respect to computation of state income taxes does not exist if there is partial dividend payout because in that case there is some corporate taxable income on which algebraic computations mentioned in note 200 *supra* can be based.

214. *See* note 204 *supra.*

because the federal individual income tax base to which the states conform their individual income tax bases is not affected by the dividend deduction method of integration.

The combined effect of the dividend deduction method of integration on the corporate and individual income taxes of the states is a decrease in state income tax revenues.

E. Dividend Exclusion

State revenues from the corporate income tax would be slightly affected by the adoption of a dividend exclusion method of integration at the federal level. There is no effect on revenues from corporations that are shareholders in other corporations in states that presently provide a full intercorporate dividend exclusion or deduction.[215] In states that do not provide a full intercorporate dividend exclusion or deduction,[216] state corporate income tax revenues from these corporations will decrease.[217]

The effect of the dividend exclusion method of integration on state individual income taxation varies. In Pennsylvania, no effect occurs because individual taxable income is computed without regard to federal taxable income. In Florida, no effect occurs because no individual income tax exists. In states in which the individual income tax base conforms to the federal income tax base, the effect depends on the technical language of the state tax law. In Illinois, there is no effect because the tax statute requires individuals to add to taxable income all dividends that were excluded from federal gross income.[218] Because New York and Ohio do not have similar provisions[219] individual income tax revenues in these states will decrease because the dividends excluded from federal taxable income are not added back.[220]

The combined effect of the dividend exclusion method varies from state to state. In Florida, the result is a decrease in corporate income tax revenues from corporations that are shareholders. The amount of the decrease is the extent of the tax attributable to the

215. *See, e.g.,* OHIO REV. CODE ANN. § 5733.04(I)(4), (6), (7), (8) (Page 1973); 72 PA. CONS. STAT. ANN. § 7401(3) (Purdon Supp. 1977).

216. New York permits exclusion of one-half of dividends received from corporations that are not subsidiaries, and of all dividends from subsidiaries. N.Y. TAX LAW ch. 60, § 208(9)(a)(1), (2) (McKinney Supp. 1981). Florida and Illinois adopt the federal 85% dividend received deduction. FLA. STAT. ANN. § 220.13(2) (West Supp. 1981); ILL. ANN. STAT. ch. 120, § 2-203(d)(1) (Smith-Hurd Supp. 1981). *See* note 3 *supra.*

217. *See* note 204 *supra.*

218. ILL. ANN. STAT. ch. 120, § 2-203(a)(2)(A) (Smith-Hurd Supp. 1981).

219. If the provision in the state tax law that requires individuals to add back dividends excluded from federal gross income does so by reference to section 116 of the Internal Revenue Code, the outcome will change depending on whether the dividend exclusion underlying integration at the federal level is placed in section 116.

220. *See* note 208 *supra.*

fifteen percent of intercorporate dividends not already excluded.[221] Pennsylvania will experience no effect since corporations that are shareholders presently exclude intercorporate dividends,[222] and individual income taxes are computed without regard to federal taxable income. In Ohio, state income tax revenues decrease as a result of the exclusion of dividends from individual taxable income.[223] The effect is the same in New York, except an additional decrease in state income tax revenues results because certain intercorporate dividends not presently excluded are excluded.[224] In Illinois, as in Florida,[225] corporations are required to add back excluded dividends to taxable income, with a resultant decrease in corporate income tax revenues from corporations that are shareholders.

F. Split Corporate Tax Rates

Because the split-value method of integration involves the computation of tax and not taxable income, states will not be affected by adoption of this method at the federal level.[226] No state requires corporations to compute state income tax liability as a percentage of federal income tax liability.[227]

G. Repeal of Corporate Income Tax

States that require corporations to compute state taxable income by making adjustments to federal taxable income would be adversely affected by the repeal of the federal corporate income tax. If the double taxation of corporate earnings distributed as dividends is terminated by repeal of the federal corporate income tax, state taxable income of the corporation will be zero, unless the corporation has items of income excluded from its federal gross income or has taken deductions on its federal return for which there are adjustments required by the state tax law. The states, therefore, will experience a drastic decrease in corporate income tax revenues.[228]

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221. *Id.*
222. *Id.*
223. *See* notes 219-20 and accompanying text *supra.*
224. *See* note 216 *supra.* In New York, the relative proportion of shareholders that are corporations and the average corporate income tax rate in comparison to the average individual income tax rate will affect the measurement of the revenue loss, in the same manner as those factors affect the analysis of the dividend credit method of integration. *See* note 212 *supra.*
225. *See* note 216 and accompanying text *supra.*
226. Even though the imposition of a zero percent tax on income that is distributed as dividends is a form of split-rate integration that produces the same result at the federal level as the dividend deduction method of integration, *see* note 37 *supra*, the effect at the state level differs because the latter method relies on a change in the definition of taxable income while the former does not.
227. If there were such states, their revenues from the corporate income tax would be affected. This analysis is pursued no further in this article.
228. The effect at the corporate level is the same as it is with respect to full integration. *See* note 188 and accompanying text *supra.*

Adoption of integration by repeal of the federal corporate income tax will not affect state individual income tax revenue because individual income tax is not changed under this method.[229]

The combined effect of the repeal of the federal corporate income tax is a significant decrease in state income tax revenues.

IV. The State in Isolation: The Response to Income Tax Integration

A. *Reasons for Response*

1. *Adoption of Integration*

(a) Automatic.—A state may effectively adopt certain methods of integration if its tax law contains a provision that automatically adopts any change in the federal tax law relating to the computation of gross, adjusted gross, or taxable income.[230] The Illinois tax law, for example, provides as follows:

> [A] taxpayer's gross income, adjusted gross income, or taxable income for the taxable year shall mean the amount of gross income, adjusted gross income or taxable income properly reportable for federal income tax purposes for the taxable year under the provisions of the Internal Revenue Code.[231]

In states whose corporate and individual income tax bases conform to the federal income tax bases,[232] automatic adoption of virtually[233] full integration will occur.[234] Automatic adoption of the dividend credit and dividend exclusion methods of integration will occur if a state bases individual income tax liability on a percentage of federal income tax liability after credits.[235] A state whose corporate taxable

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229. If the $100 dividend exclusion were repealed, *see* note 40 *supra,* states that have adopted this provision of the federal law in their conformity to the federal income tax system would experience a slight increase in individual income tax revenues. *See* notes 219-20 and accompanying text *supra.*

230. This type of provision does not cause adoption of the split-rate method of integration.

231. ILL. ANN. STAT. ch. 120, § 2-203(d)(1) (Smith-Hurd Supp. 1977). This provision is permitted by the Illinois Constitution, which provides:

> Laws imposing taxes on or measured by income may adopt by reference provisions of the laws and regulations of the United States, as they then exist or thereafter may be changed, for the purpose of arriving at the amount of income upon which the tax is imposed.

ILL. CONST. art. IX, § 3(b). The use of automatic "trigger" statutes that cause state adoption of *all* federal tax law changes without state legislative action has probably stopped. See the description of the experience of Oregon with such a provision in REPORT OF THE SPECIAL COMMITTEE OF THE NATIONAL ASSOCIATION OF TAX ADMINISTRATORS, FEDERAL COLLECTION OF STATE INDIVIDUAL INCOME TAXES UNDER PUBLIC LAW 92-512, at 28-29 (1972) [hereinafter cited as NATA REPORT]. *See* note 181 *supra.*

232. Twenty-eight states have corporate and individual income tax bases that conform to the respective federal base. *See* 41 STATE TAX REV. (CCH) No. 51, at 4-7 (December 16, 1980).

233. The existence of state adjustments to federal taxable income prevents complete adoption of full integration. *See* notes 184-88 and accompanying text *supra.*

234. *See* notes 193-201 and accompanying text *supra.*

235. If the state income tax liability of an individual is computed as a percentage of fed-

income base conforms to the federal corporate taxable income base will automatically adopt the dividend deduction and corporate income tax repeal methods of integration, unless the state tax law has provisions preventing this effect.[236] Automatic adoption of the dividend exclusion method of integration will result in a state if its individual taxable income base conforms to the federal individual income tax base, unless its tax law requires the add-back of dividends.[237] Finally, in Florida, which has no individual income tax, a form of integration already exists since dividends are not taxed twice.[238]

(b) Piggybacking.—A "piggybacking" system includes an agreement between a state and the Secretary of the Treasury for federal collection of state income taxes. If piggybacking is in effect when integration is adopted at the federal level, automatic adoption of integration will occur. The piggybacking provisions of the Internal Revenue Code[239] apply only if the individual income taxes of the state that enters into the federal collection agreement conform to the federal income tax base.[240] Thus, unless a state is willing to withdraw from a piggybacking agreement that is in effect between itself and the Secretary of the Treasury, it will adopt integration.

(c) Precedent and tradition.—States whose tax laws do not cause automatic adoption of income tax integration may find that tradition mandates the adoption of integration. At least thirty-three states have individual income tax bases that conform to the federal individual income tax base.[241] At least thirty-five states have corporate income tax bases that conform to the federal corporate income tax base.[242] If the state tax law conforms to the federal individual income tax base on a particular date,[243] or if the method of integration adopted at the federal level is one that does not cause an auto-

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eral income tax liability before federal credits, there will not be complete adoption of the dividend credit method of integration. *See* note 205 *supra.*

236. *See* note 181 *supra.*

237. *See* note 218 and accompanying text *supra.* If the provision in the state tax law that requires individuals to add back dividends excluded from federal gross income does so by reference to section 116 of the Internal Revenue Code, integration will be adopted if the dividend exclusion underlying integration at the federal level is not placed in section 116. *See* note 219 *supra.*

238. As explained in the text accompanying note 194 *supra*, however, the immediate effect of the adoption of full integration at the federal level on the income tax system of Florida would be no taxation of corporate earnings, whether or not distributed as dividends.

239. I.R.C. §§ 6361-6365.

240. *Id.* § 6362. The conformity can be by reference to federal taxable income or adjusted gross income, or the computation of state income tax liability by reference to federal income tax liability. *See* note 191 *supra.*

241. *See* note 191 *supra.*

242. *See* note 181 *supra.*

243. *Id.*

matic adoption of integration under the state tax law,[244] integration will not be adopted by the state unless it affirmatively decides to do so. If a state does not adopt integration, its individual tax system will be considerably dissimilar to the federal system. The state will lose its traditional similarity to the federal system, and the benefits of that similarity.[245] Subtle political pressure may persuade the state to follow in the footsteps of the federal government.[246] Although some states structure their income tax systems independently of the federal system,[247] a substantial number follow the federal structure, indicating a reluctance to stray from federal statutory tax precedent. Many states follow, either fully or partially, the federal integration treatment of Subchapter S corporations[248] and DISCs.[249] Hence, it is possible that integration will occur even in states in which adoption is not automatic.

(d) Internal revenue gain.—A state might adopt integration because it anticipates an increase in income tax revenues.[250] For example, adoption of full integration at the federal level would cause increased revenues in a state if the state's corporate and individual income tax bases conform to the federal base, provided that the average individual income tax rate exceeds the average corporate income tax rate and the average corporate dividend rate is not too close to full earnings distribution.[251] Increased revenues would also occur in a state whose corporate and individual income tax bases conform to the federal base if the dividend credit method of integration were adopted at the federal level.[252] As noted below,[253] however, this aspect of the adoption of income tax integration at the federal level is significant only as an analytical starting-point—when the state examines its revenue position in light of the existence of other states in the federal system.

244. The split-rate method of integration is an example. *See* notes 226-27 and accompanying text *supra.*

245. This may trouble some state taxpayers. *See* note 258 and accompanying text *infra.*

246. The proponents of integration at the federal level probably will focus on the state legislatures if they are successful in Congress.

247. Pennsylvania for example, has adopted a very unique individual income tax. *See* note 190 and accompanying text *supra.*

248. *See, e.g.,* notes 98-99 and accompanying text *supra.* For additional examples of administrative variations of state income tax treatment of Subchapter S corporations, see notes 521-31 and accompanying text *infra.*

249. *See, e.g.,* notes 116-20 and accompanying text *supra.* There is also some degree of state conformity with respect to regulated investment companies and real estate investment trusts, which resemble integration. *See, e.g.,* OHIO REV. CODE ANN. § 5733.04 (Page 1973).

250. *See* notes 178-80 and accompanying text *supra.*

251. *See* Appendix I *infra.*

252. *See* Appendix II *infra.*

253. *See* notes 330-41 and accompanying text *infra.*

(e) External revenue gain.—An anticipated shift of income tax revenue from outside a state to within it might persuade the state to adopt integration. This extremely complex aspect of the adoption of income tax integration at the federal level is explored below.[254]

(f) Administrative and pragmatic reasons.—A state might adopt integration to avoid administrative and pragmatic problems that would otherwise arise. If the federal government ceases to impose an income tax on corporations,[255] the state that continues such a tax will be required to assume the burden of developing the law and policy of corporate income tax. This problem would not be immediately noticeable, but would be aggravated as social, economic, and political climates change. The state that continues a corporate income tax would lose the benefits of congressional studies, Treasury regulations and rulings, and federal judicial resolutions.[256] Most states that reject integration[257] must develop special adjustments to their tax statutes and tax forms. The additional complexity to the state tax statute alone is a serious problem.[258]

2. *Rejection of Integration*

(a) Automatic.—A state may, in effect, reject integration because its state tax laws are so independent of federal tax laws that under certain methods of integration there is no change in state corporate and individual income taxation. For example, the split-rate method of integration is automatically rejected because it has no effect on any state.[259] In Pennsylvania, where individual income taxation is independent of the federal system, the dividend credit[260] and dividend exclusion[261] methods of integration will be rejected until the legislature affirmatively adopts integration.

(b) Constitutional problems.—The constitution of a state could require rejection of one or more methods of integration. For example, the Illinois Constitution provides that "tax on or measured by income shall be at a non-graduated rate"[262] and therefore precludes adoption of the split-rate method of integration. The constitution of

254. *Id.*
255. This occurs if full integration is adopted and if the corporate income tax is repealed. *See* notes 21-25, 39-40 and accompanying text *supra.*
256. This is not to suggest that a state could not maintain a corporate income tax system in the absence of a comparable federal corporate income tax.
257. *See* notes 290-314 and accompanying text *infra.* This is not true with respect to the split-rate method of integration.
258. This is especially true if the state has intentionally taken advantage of conformity to the federal income tax system.
259. *See* notes 226-27 and accompanying text *supra.*
260. *See* notes 201-12 and accompanying text *supra.*
261. *See* notes 215-25 and accompanying text *supra.*
262. ILL. CONST. art. IX, § 3(a).

New York provides that "[u]ndistributed profits shall not be taxed."[263] This provision apparently prevents adoption of full integration.[264] In a case upholding the taxation of a shareholder on his share of the undistributed taxable income of a Subchapter S corporation,[265] however, a New York court held the constitutional provision to be offset by another constitutional provision[266] that authorizes adoption of federal law in any New York law imposing an income tax.[267]

(c) State autonomy.—A state's desire to be independent of the federal income tax system could cause it to ignore the federal adoption of integration. This reaction parallels the reaction of states whose tax systems have traditional similarity to the federal system.

(d) Internal revenue loss.—Under certain circumstances, a state might reject integration because adoption would result in a decrease in income tax revenues.[268] If full integration, for example, were adopted at the federal level a decrease in revenue would result in a state whose tax base conforms to the federal base, but with no individual income tax,[269] or with an individual income tax that is computed without regard to the federal system.[270] A similar effect would result in a state whose corporate and individual income tax bases conform to the federal base if full integration is adopted at the federal level, provided that the average corporate income tax rate exceeds the average individual income tax rate.[271] A third example arises in a state whose corporate income tax base conforms to the federal base if a dividend deduction or corporate income tax repeal method of integration is adopted at the federal level.[272] A final example involves adoption of a dividend exclusion method of integration at the federal level and states with a tax system similar to those in Florida, Ohio, New York, or Illinois.[273] This aspect of the adoption of income tax integration at the federal level should not be of much significance, however, when the state examines its revenue position in light of the existence of other states in a federal system.[274]

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263. N.Y. CONST. art. XVI, § 3.

264. *See* Letter from James H. Tully, Jr., Commissioner of Taxation and Finance, State of New York, to James E. Maule (January 11, 1978) at 4 (on file at the Dickinson School of Law).

265. *See* notes 93, 96 and accompanying text *supra.*

266. N.Y. CONST. art. III, § 22.

267. Garlin v. Murphy, 51 Misc. 2d 477, 273 N.Y.S.2d 374 (1966).

268. *See* notes 178-80 and accompanying text *supra.*

269. *See* notes 189-91 and accompanying text *supra.*

270. *See* note 195 and accompanying text *supra.*

271. *See* Appendix I *infra*. Another example is if the average individual income tax rate exceeds the average corporate income tax rate and the average corporate dividend payout rate is sufficiently high. *See* column 3 of illustration at Appendix I *infra*.

272. *See* notes 213-15, 228-29 and accompanying text *supra.*

273. *See* notes 221-25 and accompanying text *supra.*

274. *See* notes 330-41 and accompanying text *infra.*

(e) External revenue loss.—Integration could be rejected by a state because it anticipates a shift of income tax revenue from within its borders to outside them. This extremely complex aspect of the adoption of income tax integration at the federal level is explored below.[275]

(f) Administrative and pragmatic reasons.—A state might reject integration to avoid administrative and pragmatic problems that otherwise would arise.[276] Numerous problems exist even if no nonresident corporations or shareholders are subject to income taxation by a state that adopts integration.[277] Under full integration or a dividend credit method of integration, for example, corporations would be required to maintain detailed tax records on each shareholder, just as partnerships must maintain tax records for their partners.[278] These problems would be similar to those experienced by Massachusetts with its integrated property tax.[279] The advent of computerized record keeping, however, would minimize problems in this area.[280]

Unresolved issues at the federal level pose serious problems for states and may detract from the desirability of integration. Although a state that adopts integration probably will accept the federal resolution of these issues, a state could decide that the federal resolution creates additional problems. The state that resolves the problem differently than at the federal level might find that the resolution itself will create problems. If these problems are sufficiently troublesome or require solutions that conflict with fundamental state policy, the state might decide to reject integration. Some of these problems[281] are the treatment of shareholders who own stock for less than a full taxable year,[282] the treatment of subsequent audit adjustments to corporate distributive or taxable income,[283] and the treatment of shareholders that are tax-exempt organizations.[284] Other problems include the need for transitional rules to specify the treatment of ac-

275. *Id.*

276. Many of these problems involve the interstate aspects of state income taxation and are discussed in notes 330-502 and accompanying text *infra.*

277. The interstate aspects of state income taxation compounds these problems.

278. *See* McKessy, *supra* note 7, in which the author states that the "filing tax requirements that partnerships and their partners must comply with are currently the most burdensome that any form of business can or will encounter." *Id.* at 378. Mr. McKessy suggests that the paperwork will overwhelm taxpayer and tax administrator alike, as well as hinder enforcement and discourage compliance. *Id.*

279. *See* notes 52-63 and accompanying text *supra.*

280. *But see* Clarke, *supra* note 7, at 376. The position suggested by Mr. Clarke finds support in the phenomenal increase in the number and complexity of corporate transactions in the past one hundred years, which might more than offset the advances in the computerized data processing field made in the past twenty-five years.

281. These problems do not arise with respect to every method of income tax integration.

282. *See* BLUEPRINTS, *supra* note 21, at 71; Gourevitch, *supra* note 26, at 87.

283. *See* BLUEPRINTS, *supra* note 21, at 74; Gourevitch, *supra* note 26, at 87.

284. Comm. on Corporations of the Tax Section of the N.Y. St. Bar A., *supra* note 1, at 49.

cumulated undistributed income[285] and the treatment of dividends paid in property and constructive dividends.[286]

An interesting pragmatic issue is whether integration will benefit a state economy as it presumably will benefit the national economy.[287] The problems that proponents of integration seek to solve at the federal level may not exist at the state level,[288] and a state therefore may not necessarily require integration.[289]

B. Methods of Rejecting Integration

1. Full Integration.—States that require corporations to compute state taxable income by making adjustments to federal taxable income can easily avoid the effect that full integration at the federal level might have on state corporate income taxation.[290] Since corporations are required under full integration to continue computing federal net income to determine the distributive share of each shareholder,[291] states can require corporations to compute state taxable income by making adjustments to federal net income.[292]

Whether a state must adjust its individual income tax if full integration is adopted at the federal level depends on the effect of full integration on the individual income tax system of the state. In Pennsylvania, no response is required because the adoption of full integration at the federal level does not affect the individual income tax.[293] States whose individual income tax base conforms to the federal income tax base can avoid the effect on state individual income taxation of full integration[294] by requiring shareholders to deduct

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285. *See* Cohen, *supra* note 22, at 361, 366; McLure, *Integration of Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals, supra* note 1, at 567.

286. Comm. on Corporations of the Tax Section of the N.Y. St. Bar A., *supra* note 1, at 55-56.

287. The proponents of income tax integration argue that its adoption would enhance capital formation. *See* note 4 *supra*.

288. McKessy, *supra* note 7, at 377. Mr. McKessy mentions the special state taxation of certain businesses and the lack of a federal property or sales tax. *Id.*

289. Although this may be true, the double taxation of dividends by states, from the standpoint of the national economy, compounds the effect of double taxation at the federal level.

290. *See* notes 181-88 and accompanying text *supra*.

291. *See* note 185 *supra*; Letter from Richard A. Levin, Research Director, State of Ohio Department of Taxation, to James E. Maule (December 6, 1977) at 2 (on file at the Dickinson School of Law).

292. There probably will be very little difference between federal corporate taxable income and federal corporate net income. If certain items such as corporate charitable contributions are separately stated, the state will need to net the items together. Another difference would arise from the probable repeal of the inter-corporate dividends received deduction. An adjustment to continue the deduction at the state level will be needed in states that presently provide for it. *See* Letter from Richard A. Levin, Research Director, State of Ohio Department of Taxation, to James E. Maule (December 6, 1977) at 2 (on file at the Dickinson School of Law).

293. *See* notes 189-90 and accompanying text *supra*.

294. *See* notes 191-92 and accompanying text *supra*.

their shares of undistributed taxable income of corporations[295] from federal taxable income,[296] for purposes of computing state taxable income.

2. Dividend Credit.—Generally, if the dividend credit method of integration is adopted, states need not alter the corporate income tax to avoid adopting integration.[297] Some action will be needed, however, to avoid the effect of the dividend credit method on the computation of corporate taxable income by corporations that are shareholders.[298] The necessary adjustment is identical to the adjustment required in the individual income tax of states with individual income tax bases that conform to the federal income tax base.[299]

As with full integration, a state's decision to modify the individual income tax in response to the adoption of the dividend credit method depends on the effect of the dividend credit method of integration on the individual income tax system of the state. In Pennsylvania, no action is required because adoption of the dividend credit method of integration will not affect its individual income tax.[300] States whose individual income tax bases conform to the federal income tax base can avoid the effect on state individual income taxation of the dividend credit method of integration[301] by requiring shareholders to deduct their share of the federal corporate income tax attributable to the dividend from federal taxable income[302] for purposes of computing state taxable income.

295. Undistributed taxable income of corporations is the distributive share of corporate net income minus dividends. This formulation will permit the state to tax dividends.

296. *See* Letter from Richard A. Levin, Research Director, State of Ohio Department of Taxation, to James E. Maule (December 6, 1977) at 2 (on file at the Dickinson School of Law). For the few states that require individuals to compute income tax liability as a percentage of federal income tax liability, the adjustment will be somewhat complex. These states must allow a credit against the income tax liability of the individual in an amount equal to the federal income tax liability of the individual with respect to the undistributed taxable income of the corporation, multiplied by the percentage used to compute state income tax liability from federal income tax liability. *See* note 295 *supra*. This raises the issue of how to compute the federal income tax liability of an individual on the undistributed taxable income of the corporation.

297. *See* note 201 and accompanying text *supra*.

298. *See* notes 202-04 and accompanying text *supra*.

299. Even states that do not need to adjust their taxation of individual income must alter taxation of corporate income to reject income tax integration.

300. *See* note 205 and accompanying text *supra*.

301. *See* notes 205-08 and accompanying text *supra*.

302. *See* Letter from Richard A. Levin, Research Director, State of Ohio Department of Taxation, to James E. Maule (December 6, 1977) at 3 (on file at the Dickinson School of Law). For the few states that require individuals to compute income tax liability as a percentage of federal income tax liability, the adjustment will be rather complex. These states will need to do several things. First, these states will need to add to the tax liability of the individual an amount equal to the federal corporate income tax attributable to the dividend, multiplied by the percentage used to compute state income tax liability from federal income tax liability. Second, these states will need to allow a credit against the tax liability of the individual in an amount equal to the federal income tax liability of the individual on the corporate income tax attributable to the dividend, multiplied by the percentage used to compute state income tax liability from federal income tax liability. As with full integration, this raises the issue of how

3. Dividend Deduction.—States that require corporations to compute state taxable income by making adjustments to federal taxable income can easily avoid the effect of the dividend deduction method at the federal level on state corporate income taxation.[303] Since corporations are allowed a deduction for dividends paid under the dividend deduction method of integration, these states can require corporations to add back the dividends paid deduction to federal taxable income for purposes of computing state taxable income.[304]

Since the adoption of the dividend deduction method of integration at the federal level does not affect state individual income taxation,[305] states can reject integration by inaction with respect to the individual income tax.[306]

4. Dividend Exclusion.—In general, states adjust the corporate income tax to avoid adopting integration if the federal government adopts the dividend exclusion method of integration.[307] Some action will be needed, however, to avoid the effect of the dividend exclusion method on computation of corporate taxable income in those states where the amount, if any, of the intercorporate dividend exclusion or deduction is increased by the adoption of this method of integration.[308] In these states, corporations that are shareholders must be required to add back to federal taxable income, in computing state taxable income, the portion of the intercorporate dividend that the state does not wish to exclude from state income taxation.

As with full integration and the dividend credit method of integration, whether a state must respond by adjusting its individual income tax if the dividend exclusion method is adopted at the federal level depends on the effect of the dividend exclusion method of integration on the individual income tax system of the state. In Pennsylvania and Illinois, no action is required because the adoption of the dividend exclusion method does not affect their individual income tax.[309] In New York and Ohio, individuals, in computing state taxable income, must be required to add back to federal taxable income the dividends that the state does not wish to exclude from state

to compute the federal income tax liability of an individual on the corporate income tax attributable to the dividend. *See* note 296 *supra.*

303. *See* notes 213-14 and accompanying text *supra.*

304. *See* Letter from Richard A. Levin, Research Director, State of Ohio Department of Taxation, to James E. Maule (December 6, 1977) at 2 (on file at the Dickinson School of Law).

305. *See* note 215 and accompanying text *supra.*

306. Of course, the proper corporate adjustments must be made. *See* note 304 and accompanying text *supra.*

307. *See* note 215 and accompanying text *supra.*

308. *See* notes 216-17 and accompanying text *supra.*

309. *See* note 218 and accompanying text *supra.*

income taxation.[310]

5. Split Corporate Tax Rate.—Since adoption of the split-rate method of integration at the federal level does not effect state income taxation,[311] the states can reject integration by inaction.

6. Repeal of Corporate Income Tax.—States that require corporations to compute state taxable income by making adjustments to federal taxable income must take steps to avoid the effect that repeal of federal corporate income tax would have on state corporate income taxation. These states must define corporate taxable income either by adoption of their own sets of rules for gross income and deductions or by reference to the Internal Revenue Code as it existed prior to the repeal of the federal corporate income tax. Both methods require the states to assume responsibility for shaping corporate income tax policy in the future.[312]

Since repeal of the federal corporate income tax does not affect state individual income taxation,[313] the states can effectively reject integration by allowing the individual income tax to remain intact.[314]

C. Methods of Adopting Integration

1. Full Integration.—States that require corporations to compute state taxable income by making adjustments to federal taxable income can adopt full integration by not changing the corporate income tax.[315]

The effect of full integration at the federal level on the state individual income tax system determines whether the state must act upon its individual income tax to adopt full integration. States whose individual income tax base conforms to the federal income

310. If a state that requires that dividends excluded from gross income be added back to state taxable income does so by reference to section 116 of the Internal Revenue Code, there is no need for action if the federal dividend exclusion provisions are placed in section 116. If the federal provisions are placed in another section, however, the action required by the state is the addition of a reference to that section in the provisions of its income tax law requiring that dividends excluded from gross income be added back to state taxable income. *See* note 219 *supra*.

311. *See* notes 226-27 and accompanying text *supra*.

312. *See* notes 255-56 and accompanying text *supra*.

313. *See* note 218 and accompanying text *supra*.

314. Of course, the proper corporate adjustments must be made.

315. Two technical amendments would be required. One amendment is needed to require shareholders to include in taxable income their distributive shares of the adjustments to federal corporate taxable income for purposes of computing state corporate taxable income under present law. *See* notes 184-87 and accompanying text *supra*. The second amendment is needed to repeal the requirement that state corporate income taxes deducted in computing federal taxable income of corporations must be added back to that income. This amendment would resolve the problem outlined in note 200 *supra*. These amendments are not needed by states that require individuals to compute income tax liability as a percentage of federal income tax liability.

tax base can adopt full integration by inaction.[316] In Pennsylvania, the state tax law would need a new provision requiring individuals to include in income their shares of the undistributed net income of the corporation.[317]

2. *Dividend Credit.*—States will not need to modify the corporate income tax to adopt the dividend credit method of integration because this method generally does not affect the income taxation of corporations.[318] Certain adjustments must be made, however, in the computation of corporate tax liability by corporations that are shareholders.[319] These modifications are identical to the adjustments that are necessary in the individual income tax of states whose individual income tax bases conform to the federal income tax base.

The changes that must be made in the individual income tax in order to adopt the dividend credit method vary according to the individual income tax system of the particular state. Pennsylvania tax law would need two new provisions. One provision would permit individuals receiving corporate dividends to claim a tax credit for the portion of the state income tax paid by the corporation that is attributable to those dividends. A second provision would include that credit in the income of the individuals. States whose individual income tax bases conform to the federal income tax base must take the two steps necessary in Pennsylvania and add a third step.[320] The third step requires shareholders to deduct their share of the corporate federal income tax attributable to the dividend from taxable income.[321]

3. *Dividend Deduction.*—States that require corporations to compute state taxable income by making adjustments to federal tax-

316. This conclusion assumes that proper action is taken regarding the corporate income tax. *See* note 315 *supra.*

317. *See* note 295 *supra.*

318. *See* note 202 and accompanying text *supra.*

319. *See* notes 202-04 and accompanying text *supra.*

320. *See* note 321 and accompanying text *infra.* For the few states that require individuals to compute income tax liability as a percentage of federal income tax liability, the required steps are quite complex. First, the steps outlined in note 302 *supra* must be taken. Next, the state income tax paid by the corporation that is attributable to the dividends must be computed. *See* note 296 *supra.* The amount so computed is the dividend credit against the state income tax liability of the shareholder. In addition, however, this state credit must itself be included, in effect, in state taxable income. To do so, the federal income tax liability that would be attributable to that state income tax if it were included in federal taxable income must be computed, and multiplied by the percentage used to compute state income tax liability from Federal income tax liability.

It is incorrect to assume that since the federal income tax liability of individuals in these states reflects the adoption of the dividend credit method of integration, no action must be taken. The complexity arises because the federal income tax liability takes into account *federal* income taxes paid by the corporation, and not *state* income taxes paid by it.

321. *See* note 302 and accompanying text *supra.* For the few states that require individuals to compute income tax liability as a percentage of federal income tax liability, this step requires the complicated computations outlined in note 302 *supra.*

able income can adopt the dividend deduction method of integration without changing the corporate income tax. Similarly, states need not alter the individual income tax in order to adopt integration since adoption of the dividend deduction method at the federal level does not affect state individual income taxation.[322]

4. Dividend Exclusion.—The corporate income tax does not have to be modified by the state in order to adopt the dividend exclusion method of integration because adoption of that method does not affect income taxation of corporations that pay dividends.[323] Since corporations that are shareholders exclude or deduct intercorporate dividends from federal taxable income in computing state taxable income as a consequence of the dividend exclusion method of integration no action is needed to adopt integration. The computation of the state taxable income of these corporations is essentially unchanged.[324]

The nature of the individual income tax system of a state determines whether modifications must be made in the individual income tax in order to adopt the dividend exclusion method. In New York and Ohio, no action is necessary because individuals in these states would exclude dividends from taxable income if the dividend exclusion method were adopted at the federal level.[325] Illinois would need to repeal its provision requiring individuals to add back to taxable income all dividends that were excluded from federal gross income.[326] Pennsylvania tax law would need a new provision permitting individuals to exclude dividends from gross income.[327]

5. Split Corporate Tax Rates.—A state can adopt the split-rate method of integration by adjusting its corporate income tax rates to provide a lower rate on corporate income distributed as dividends. The individual income tax does not need to be altered.

6. Repeal of Corporate Income Tax.—States requiring corporations to compute state taxable income by making adjustments to federal taxable income would need to eliminate those adjustments in order to eliminate the state income tax on this income.[328] Since re-

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322. *See* note 215 and accompanying text *supra.*
323. *Id.*
324. *See* notes 216-17 and accompanying text *supra.*
325. *See* notes 219-20 and accompanying text *supra.*
326. *See* note 218 and accompanying text *supra.*
327. If a state that requires that dividends excluded from gross income be added back to state taxable income does so by reference to section 116 of the Internal Revenue Code, there is no need for action if section 116 is repealed, but action must be taken if the federal dividend exclusion provisions are placed in section 116. This result is the opposite of that needed to reject integration. *See* note 310 *supra.*
328. *See* note 228 and accompanying text *supra.*

peal of the federal corporate income tax does not affect state individual income taxation,[329] states do not need to adjust the individual income tax to adopt this method of integration.

V. The State in a Federal System: The Effect of Income Tax Integration

A. Revenue Shifts

Since shareholders are often residents of states other than those in which their corporation is resident,[330] it seems likely that full integration or the dividend credit method of integration at the federal level will cause sizeable revenue shifts among the states.[331] The federal nature of modern business transactions could also prevent maximum achievement of the goals a state sets when it decides to adopt or reject integration. An examination of the fundamental premises of revenue shifts aids analysis of the situation.[332]

Full integration causes a shifting of income tax liability from the corporation to the shareholder.[333] The basic premise of revenue shifting applicable when full integration occurs is that income tax revenues shift from states with a proportionately larger share of *corporate* residents to those with a proportionately larger share of *shareholder* residents. For example, if a corporation is a resident of Ohio and its shareholders are residents of Illinois, the tax revenues of Illinois will increase while those of Ohio will decrease.[334] Certain steps can be taken to avoid this consequence.[335]

The basic premise when the dividend credit method of integration is adopted is the opposite of the premise that is applicable to full integration. The dividend credit method causes a shifting of income tax liability from the shareholder to the corporation if the marginal tax rate of the shareholder is less than the corporate tax rate. It causes a shifting of income tax liability from the corporation to the shareholder if the marginal tax rate of the shareholder is greater than the corporate tax rate.[336] Consequently, income tax revenues will

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329. *See* note 229 and accompanying text *supra*.

330. *See* notes 178-79 *supra*.

331. *See* Comm. on Corporations of the Tax Section of the N.Y. St. Bar A., *supra* note 1, at 63. One writer called these shifts "serious" and "disastrous." Clarke, *supra* note 7, at 375.

332. These revenue shifts are analyzed in the next section. *See* notes 357-502 and accompanying text *infra*. Moreover, due to the complex nature of the federal relationship among the states, the effect of the response of one state in adopting or rejecting integration on the income tax system of another state may be different from the effect of its doing nothing in response to the adoption at the federal level of income tax integration. As to a third state, no effect may occur.

333. Shareholders would pay *all*, not a portion as they presently pay, of the income tax revenues attributable to corporate net income.

334. *See* McKessy, *supra* note 7, at 378-79.

335. *See* notes 360-445 and accompanying text *infra*. For example, these steps might include taxation by Ohio of the Illinois shareholders.

336. The shareholder dividend credit usually will exceed the individual income tax on

shift from states with shareholder residents with relatively lower marginal tax rates to states with shareholder residents with relatively higher marginal tax rates, assuming no difference exists in the proportionate distribution of corporate residents. If the proportionate distribution of corporate residents is unequal, variations and reversals of the revenue shifts will occur.[337]

The basic premise underlying revenue shifts among the states when the dividend deduction, corporate tax repeal, and split-rate methods of integration are adopted is that corporate income tax revenue losses will affect states that collect relatively more tax from corporations than from shareholders.[338] This occurs because revenue losses[339] are at the corporate income tax level[340] under these methods.

Finally, if the dividend exclusion method of integration is adopted, individual income tax revenue losses will affect states that collect relatively more tax from shareholders than from corporations. This occurs because revenue losses are at the individual income tax level under the dividend exclusion method.[341]

B. Equity Considerations

Income tax integration presents the states with a serious question about the source of the revenues they use to provide services to their corporate and individual residents. This question primarily arises if the state income tax burden is shifted from the corporation to the individual. It also arises if the shift is in the opposite direction or if the state rejects integration, because the responses of the other states to integration will affect residents of the state that adopts or rejects integration.[342]

The question about the source of the revenues used to provide state services can be illustrated by a simple example of income tax integration at the state level.[343] Assume that two states, Massachusetts and Mississippi, take the steps necessary to conform their income tax systems to the adoption of full integration at the federal

dividends, except in the highest individual income tax brackets. *See* illustration in Appendix II *infra*.

337. The various permutations of these factors are too numerous and complex to illustrate individually in this article.

338. *See* Comm. on Corporations of the Tax Section of the N.Y. St. Bar A., *supra* note 1, at 63.

339. The revenue losses are caused by elimination of the double taxation of corporate earnings distributed as dividends.

340. *See* Comm'n on Corporations of the Tax Section of the N.Y. St. Bar A., *supra* note 1, at 63.

341. *See* note 224 *supra*.

342. *See* notes 357-502 and accompanying text *infra*.

343. This example, which in many ways served as a catalyst for the numerous examples in the next section, was suggested in Clarke, *supra* note 7, at 375.

level. Assume that as so conformed, the tax statutes of both states subject resident shareholders, but not nonresident shareholders, to income taxation on their shares of undistributed net income of the corporations of which they are shareholders.[344] Assume that *X* Corporation is resident in Massachusetts, and its shareholders are residents of Mississippi. Under full integration, the income of *X* Corporation is taxed by Mississippi in the hands of the shareholders, but not by Massachusetts. Massachusetts, however, must continue to provide many services directly to *X* Corporation because of the presence of corporate physical property in the state.[345]

A more complex example of integration at the state level illustrates how the question about the source of revenues used to pay for state services can arise when a state rejects integration. Assume that Massachusetts decides to reject integration and structures its income tax system to produce that result. Mississippi, on the other hand, adopts full integration and taxes its resident and nonresident shareholders only on their shares of the undistributed net income of corporations resident in Mississippi.[346] Assume that *X* Corporation is resident in Massachusetts and all except one of its shareholders are residents of Mississippi. The other shareholder is a resident of Massachusetts. Under this income tax system, *X* Corporation is subject to income taxation in Massachusetts. The shareholders who are residents of Mississippi are not subject to income tax on their share of the undistributed net income of *X* Corporation. The Massachusetts shareholder is subject to income tax by Massachusetts on any dividends received from *X* Corporation. This shareholder might raise a question of equity concerning the source of revenues used to pay for services provided by Massachusetts to *X* Corporation. The question arises because the share of the net income of *X* Corporation distributed as a dividend to the Massachusetts shareholder is subject to

344. It is probable that such a method of taxing nonresident shareholders under full integration would not be adopted. *See* McKessy, *supra* note 7, at 378-79; notes 360-445 and accompanying text *infra*.

345. One writer explained, "When a fire breaks out in the corporation's warehouse in Boston the fire alarm does not ring in Mississippi where the shareholders of that corporation might live." Clarke, *supra* note 7, at 375. The imposition of user charges is an alternative that might solve the problem of the source of revenues used by a state to provide services. See note 520 and accompanying text *infra*. However, although it is called by a different name, the user charge is a cost that would have the same economic effect on corporate earnings as a whole as does the income tax on corporate earnings distributed as dividends that income tax integration is designed to eliminate. Of course, the user charge shifts the economic burden from the user of proportionately less state services to the user of proportionately greater state services. If the argument that states do not need income tax integration is accepted, *see* note 289 and accompanying text *supra*, the user charge provides a means of avoiding the complexity caused by not conforming to income tax integration at the federal level without impairing state revenues. *See* note 520 and accompanying text *infra*.

346. Assume that Mississippi does so on its assumption that other states will tax residents of Mississippi who are shareholders in corporations in those other states. Mississippi might not structure its full integration in this manner.

greater taxation than the remainder of the net income.[347] This problem is no different than the one that exists today, however, if the shares of a corporation resident in Massachusetts with one Massachusetts shareholder are owned by residents of Florida, where dividends are not taxed.

The equity of the particular income tax system that a state uses to collect the revenues which permit it to provide services must be considered before a state can decide how to react to income tax integration at the federal level. These equity questions affect both the state response to income tax integration at the federal level and the manner in which that response is implemented, because the response must be made in the context of the state in a federal system and not in isolation.[348]

C. *Administrative Problems*

Income tax integration also presents the states with the problem of administering a method of income taxation that adopts or rejects income tax integration in the context of the federal relationship among the states. The problems of tax administration in the federal context arise if certain methods of integration are adopted at the federal level, regardless of whether the state adopts or rejects integration. Adoption of the split-rate, dividend deduction, or corporate tax repeal methods of integration at the federal level presents administrative problems primarily for states that adopt integration.[349]

Some of the problems of tax administration raised by the adoption of income tax integration at the federal level concern the federal nature of modern business transactions. Shareholders are often residents of states other than those in which the corporation is resident.[350] States must provide rules for shareholders who change their state of residence during the taxable year. These provisions must include rules for shareholders who change residence from a state that has adopted integration to a state that has not adopted it, and vice versa. Corporate reorganizations of multistate corporations whose shareholders who are residents of several states, which may or may not have adopted income tax integration, will require complex technical rules for all except the split-rate method of integration.[351]

347. Moreover Massachusetts, for example, does not provide greater fire protection for the portion of the warehouse of *X* Corporation that is attributable to the interest of the Massachusetts shareholder in *X* Corporation. *See* note 345 *supra.*

348. The myriad ways in which these issues can arise become evident when the various permutations of state reactions to income tax integration at the federal level are analyzed. *See* notes 357-502 and accompanying text *infra.*

349. *See* notes 490-95, 502 and accompanying text *infra.*

350. *See* note 331 and accompanying text *supra.*

351. States that do not adopt integration also will be able to manage without many of these special rules for corporate reorganizations if the method of integration adopted at the

Finally, states will need to administer records for nonresident shareholders, a task that the state would not have to perform in the absence of income tax integration at the federal level.[352]

Other tax administration problems that are raised by income tax integration and complicated by the federal relationship among the states are extensions of the administrative problems faced by the states in isolation.[353] Under certain circumstances, for example, states that reject integration need to make special adjustments to their tax statutes and forms.[354] The existence of nonresident corporations and shareholders increases the number of special adjustments that are required.[355] States that adopt integration face a series of problems, also presented at the federal level, relating to tax-exempt shareholders, part-year shareholders, audit adjustments, and transition rules.[356] These problems exist in greater proportions within the context of the federal system.

VI. The State in a Federal System: The Response to Income Tax Integration

A. Introduction

An analysis of the actions that states can take in response to the adoption of income tax integration at the federal level, when considered in the context of the federal relationship among the states, is quite complex. This section approaches the analysis through a series of examples,[357] based on the income tax systems of three states—Florida, Pennsylvania, and Ohio. Florida has no individual income tax. In Pennsylvania, the corporate income tax base conforms to the federal base and the individual income tax is computed independently of the federal base. The corporate and individual income tax bases of Ohio conform to the federal base.[358] Special state constitutional considerations in New York, [359] whose tax system is similar to

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federal level and by the other states is the dividend deduction or corporate tax repeal method. Nonetheless, even in these situations, the states not adopting integration will need rules for determining basis.

352. *See, e.g.,* McKessy, *supra* note 7, at 378. Under certain methods, states that reject integration will not have this problem. *See* note 278 and accompanying text *supra*.

353. *See* notes 255-58, 276-79 and accompanying text *supra*.

354. *See* note 257 and accompanying text *supra*.

355. *See* notes 255-58 and accompanying text *supra*.

356. *See* notes 282-86 and accompanying text *supra*.

357. These examples are generally not numerical, but more closely resemble a series of fact patterns.

358. *See* notes 181, 191 and accompanying text *supra*. The income tax systems in Illinois and New York are similar to the Ohio system. If the differences significantly affect the analysis of the fact patterns in this section, they will be noted.

359. The New York Constitution provides as follows:

> Moneys, . . . securities and other intangible personal property within the state not employed in carrying on any business therein by the owner shall be deemed to be located in the domicile of the owner for purposes of taxation. . . . Intangible per-

that of Ohio, are discussed when relevant to the analysis of the Ohio-type system.

The examples fall into four categories,[360] each of which focuses on the responses of the primary state in light of the actions of the secondary state.[361] Each category is based on variations of the residence of the corporation and that of its shareholders.[362] The first category is a corporation resident in the primary state with shareholders who are residents of the secondary state. The second category is a corporation resident in both the primary and secondary states,[363] and whose shareholders are residents of the secondary state. The third category is a corporation resident in the secondary state with shareholders who are residents of the primary state.[364] The fourth category is a corporation resident in both the primary and secondary states and whose shareholders are residents of the primary state.[365]

The analysis requires several assumptions. First, if a state adopts integration, it adopts the method adopted at the federal level. Second, there are no shareholders that are corporations. Although this assumption ignores, to a degree, the realities of the situation, it prevents the analysis from becoming so complicated that it hinders useful examination of the issues. Third, the analysis assumes that the method used by each state to allocate or apportion corporate income among the states is one that avoids multiple taxation.[366] This

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> sonal property shall not be taxed ad valorem nor shall any excise tax be levied solely because of the ownership or possession thereof.

N.Y. CONST. art. XVI, § 3.

360. A fifth category is the state in isolation, *i.e.,* when the corporation and its shareholders are residents of the primary state. *See* notes 230-329 and accompanying text *supra.*

361. These four categories, the six methods of integration, the three state income tax systems examined, and the three basic reactions of each state (adoption, rejection, and inaction), form the basis for developing the permutations of fact patterns analyzed in this section.

362. *See* notes 178-79 and accompanying text *supra.* For purposes of simplicity, this section does not analyze situations in which some of the shareholders are residents of one state and other shareholders are residents of another state. To analyze this situation, it is necessary to blend together in appropriate proportions the analyses of two or more relevant fact patterns.

363. As the definition of "resident" used in this article in relation to corporations indicates, this occurs if the corporation does business in both states. *See* note 178 and accompanying text *supra.*

364. Although this category is a reversal of the first category, the point of view of the primary state—the state which is analyzed in each category—changes depending on whether its resident is a corporation or shareholder. In reality, a particular state would need to examine each category since all four situations exist simultaneously. *See* note 365 and accompanying text *infra.*

365. There are limitations to an analysis based on these four categories because each state faces a combination of all four situations. Ohio, for example, has resident corporations with Illinois shareholders; resident individuals owning stock in Illinois corporations; corporations that do business in Ohio, Indiana, and Illinois that have shareholders who are residents of Ohio and Illinois, and so on. The analysis in this section can be adapted to these very complex situations by blending together in appropriate proportions the analyses of two or more relevant fact patterns.

366. For informative background analyses of the multiple taxation problem of multistate corporations, see Hellerstein, *Recent Developments in State Tax Apportionment and the Circum-*

assumption also ignores reality but, like the prior assumption, it prevents undue complication.[367] The final assumption is that individuals who are nonresidents of a state have no income in or relationship with that state, other than their ownership of stock in a corporation resident in that state.

This chapter analyzes the actions that states can take in response to the adoption of integration at the federal level and also tests the proposition of the Carter Commission that uncoordinated decision-making by the Canadian provinces on income tax integration would cause "an unsatisfactory state of affairs[,] . . . an endless debate about the rights and duties of . . . provinces[, and] an administrative nightmare."[368]

B. Full Integration

1. Corporation Resident in Primary State And Its Shareholders Residents of Secondary State

(a) Primary state does nothing.—If full integration is adopted at the federal level and the primary state—the state in which the corporation is resident—does nothing in response to the adoption of full integration, the state taxable income of the corporation will virtually vanish. The effect on the corporation is the same as it is if the corporation and its shareholders were residents of the primary state: state corporate taxable income will be zero unless there are adjustments to federal corporate taxable income that apply in the case.[369]

If full integration is adopted at the federal level, inaction by the primary state affects the income tax treatment of nonresident shareholders in various ways. In Florida and Pennsylvania, the nonresident shareholders would not be taxed.[370] This result does not differ from the result under current federal and state income tax law. In Ohio, however, the nonresident shareholders will be required to include in taxable income that portion of their federal taxable incomes that is properly allocable to Ohio.[371] Ohio's statutory provisions for allocating the income of a nonresident do not include rules for allocating distributive shares of corporate net income. Arguably, the distributive share is business income because it arises from transac-

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scription of Unitary Business, 21 NAT'L TAX J. 487 (1968); Note, *Developments in the Law: Federal Limitations on State Taxation of Interstate Business,* 75 HARV. L. REV. 953 (1962).

367. Problems arising in the area of integration that are caused by multiple taxation would be eliminated if multiple taxation is eliminated. This article does not address the elimination of multiple taxation.

368. Royal Commission on Taxation, 6 Report 197 (Ottawa 1966). *See* note 155 and accompanying text *supra.*

369. *See* notes 184-87 and accompanying text *supra.*

370. *See* notes 189, 207 and accompanying text *supra.*

371. OHIO REV. CODE ANN. §§ 5747.01(A), 5747.05(A), 5747.05(B) (Page 1973 & Supp. 1975).

tions and activities in the regular course of business;[372] therefore, it should be apportioned under the three-factor formula.[373] In this case, the distributive share would be apportioned entirely to Ohio.[374] The alternative argument—that the distributive share is a dividend and thus should not be allocated to Ohio[375]—is not as persuasive since the distributive share includes undistributed corporate net income.[376] In either case, Ohio will need to clarify the matter by amending its tax law.[377]

(b) Primary state rejects integration.—If full integration is adopted at the federal level and the primary state rejects integration,[378] the tax treatment of the resident corporation and its nonresident shareholders by the primary state will continue as under current law.[379]

(c) Primary state adopts integration—Ohio as primary state.—If full integration is adopted both at the federal level and in Ohio, an interesting constitutional question arises concerning the treatment of the nonresident shareholder.[380] The issue is whether Ohio may tax nonresident shareholders on their shares of the net income of the Ohio corporation without violating the commerce or due process clauses of the federal constitution.[381] The commerce clause prohibits states from imposing a tax that impedes interstate commerce.[382] The shift of the tax from the corporation to its nonresident shareholders probably would not impede interstate commerce because that shift would not impair the ability of the shareholders or corporation to function.[383]

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372. *Id.* § 5747.01(B).
373. *Id.* § 5747.21.
374. This result is based on the assumption that the corporation is resident in Ohio.
375. OHIO REV. CODE ANN. § 5747.20(B)(5) (Page Supp. 1975).
376. This is especially true if few or no dividends have been distributed by the corporation.
377. States that require nonresident shareholders of Subchapter S corporations to include in taxable income all or a portion of their distributive shares of the corporate net income, *see* notes 523-31 and accompanying text *infra,* can resolve the issue by analogy more easily than Ohio. *See* notes 395-405 and accompanying text *infra.*
378. *See* notes 290-96 and accompanying text *supra.*
379. The corporation might transfer its business to the secondary state if that state adopts income tax integration. Of course, nontax factors may have required the nonresident shareholders to do business in the primary state and in corporate form. If the corporate income tax burden is sufficiently great, however, integration might become a principal factor.
380. In New York, full integration might not be possible without a state constitutional amendment. *See* notes 263-72 and accompanying text *supra.* If the constitution is so amended or if Garlin v. Murphy, 51 Misc. 2d 477, 273 N.Y.S.2d 374 (1966), is extended to apply to full integration, the textual material concerning Ohio is relevant to New York.
381. U.S. CONST. art. I, § 8; U.S. CONST. amend. XIV, § 1.
382. *See* Hellerstein, *supra* note 366; Note, *supra* note 366.
383. Unless the corporation withholds, *see* notes 24-25 and accompanying text *supra,* taxpayers might argue that the lack of shareholder liquidity impedes their investment in interstate commerce. This argument is weak, however, since many shareholders will not have liquidity problems. From an economic standpoint, full integration does not change the position of the

The due process clause prevents a state from enforcing a tax beyond its jurisdiction and from imposing a tax on persons or things with only tangential relationships to the state.[384] The due process limitation is also unlikely to prevent the imposition of an Ohio income tax on the shares of the corporate net income that are attributable to nonresident shareholders. A jurisdictional basis for taxation of income of a nonresident clearly exists if the source of that income[385] is from within that state, whether the income arises by virtue of business situs or business activities.[386] Although the corporation, not the nonresident shareholders, has the property and activities in Ohio that create the jurisdictional basis for taxation, it is difficult to argue that this difference is sufficient to remove jurisdiction to tax since no successful constitutional objections have been sustained against state tax laws that tax nonresident beneficiaries of a resident trust or estate,[387] nonresident limited partners in a resident limited partnership,[388] or nonresident shareholders of a resident Subchapter S corporation.[389] Thus, Ohio will require nonresident shareholders to file income tax returns and pay tax on their shares of the net income of the corporation.[390]

Under full integration, the income tax treatment by Ohio of the nonresident shareholders raises some problems for the state in which the shareholders are resident, since the need may arise for a tax credit for taxes paid to Ohio.[391]

(d) Primary state adopts integration—Pennsylvania as primary state.—If full integration is adopted both at the federal level and in

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shareholders because they receive the same or greater after-tax income. The Supreme Court, however, does not give great weight to that aspect of the problem. *See* Note, *supra* note 366, at 956. Finally, to the extent that the proponents of income tax integration are correct in their assertion that it will help the national economy, full integration should stimulate interstate commerce.

384. *See* Note, *supra* note 366, at 961-62 & n.37.

385. This article does not discuss whether undistributed corporate net income is income realized within the constitutional meaning of realization set forth in Eisner v. MacComber, 252 U.S. 189 (1920). *See* Gabinet & Coffey, *supra* note 1.

386. *See* Note, *supra* note 366.

387. *See, e.g.,* OHIO REV. CODE ANN. § 5747.23 (Page 1973 & Supp. 1975).

388. *See, e.g.,* Chapman v. Browne, 268 App. Div. 806, 48 N.Y.S.2d 598 (1944). The argument that a partnership is a nonentity and the partner is the actual taxpayer is weak when one considers the true relationship of a limited partner to a limited partnership.

389. *See, e.g.,* Isaacson v. Iowa State Tax Comm'n, 183 N.W.2d 693 (Iowa 1971). The elective nature of the Subchapter S corporation should not be of much significance to the jurisdiction problem because the election is a federal election and should not be considered the basis for current state taxation of nonresident shareholders of Subchapter S corporations.

390. The Ohio provision that permits a partnership under certain circumstances to file a single return on behalf of its nonresident partners provides an approach to solving certain administrative problems. *See* note 81 and accompanying text *supra*; notes 521-32 and accompanying text *infra*.

391. This question is explored more fully in connection with the third category, in which the shareholders are resident in the primary state and the corporation is resident in the secondary state. *See* notes 407-24 and accompanying text *infra*.

Pennsylvania, Pennsylvania must resolve the same questions as Ohio. The inability of a partner in Pennsylvania to take into account distributive shares of partnership losses, other than to offset partnership gains, however, is an interesting gloss on the problem.[392] The nonresident shareholder, like the nonresident partner, will not be permitted to use a distributive share of a corporate loss to offset compensation, interest, or other income received from the corporation. It does not appear, however, that the shareholder would be in any worse a position than under current law.

(e) Primary state adopts integration—Florida as primary state.—Although integration effectively exists in Florida because shareholders are not taxed, Florida might decide to follow the federal system and transfer the imposition of the income tax from the corporation to its shareholders. The shareholder tax would resemble a partial income tax. Florida would then encounter the same questions as Ohio. If, on the other hand, Florida adopts integration by maintaining its current income tax system, neither resident nor nonresident shareholders would be subject to income tax.

2. *Corporation Resident in Primary and Secondary States And Its Shareholders Resident in Secondary State*

(a) Primary state does nothing.—If full integration is adopted at the federal level and the primary state—one of two states in which the corporation is resident—does nothing in response to the adoption of full integration, the outcome will be the same as if the corporation were resident only in the primary state. The federal constitution, however, does not permit the primary state to impose a tax on the nonresident shareholders' portion of the distributive share that is apportionable to the secondary state. Thus, the interpretation problems regarding allocation of distributive shares[393] must be resolved in a manner that is consistent with those constitutional limitations.

(b) Primary state rejects integration.—If full integration is adopted at the federal level and the primary state rejects integration, the tax treatment of the corporation and its nonresident shareholders by the primary state will continue as under current law.[394]

(c) Primary state adopts integration.—If full integration is adopted both at the federal level and in the primary state, a question

392. *See* note 83 *supra.*
393. *See* notes 372-77 and accompanying text *supra.*
394. *See* note 379 *supra.*

arises in addition to those that arise when the corporation is resident only in the primary state. The question involves the manner in which the primary state determines the portion of the distributive share of the nonresident shareholder that is allocable to the primary state.[395] The primary state must determine whether it will treat the distributive share of the nonresident shareholder as a dividend,[396] as business income,[397] or as the distributive share of a nonresident partner of a resident partnership.[398]

Very few clues exist in the current treatment of entities taxed at the shareholder level[399] to suggest what the primary state would decide. Since Ohio and Pennsylvania treat Subchapter S corporations as they do any other corporation, no analogy can be drawn for those states. New York does not tax nonresident shareholders of Subchapter S corporations. This approach resembles its tax treatment of dividends received by nonresidents from resident corporations,[400] but it is not a beneficial approach under full integration because of potential revenue loss.[401] Such an approach would, however, be administratively acceptable. Certain states that tax nonresident shareholders of Subchapter S corporations[402] resolve the problem by requiring the nonresident shareholder to pay tax on the part of the distributive share derived from sources within the state.[403]

Since full integration is conceptually a partnership approach to the taxation of corporations, Ohio is likely to determine the portion of the distributive share of the nonresident *shareholder* that is properly allocable to Ohio as it determines the allocation of the distributive share of a nonresident *partner*. Alternatively, Ohio could follow the approach of the states that require nonresident shareholders of Subchapter S corporations to include in state taxable income the portion of their distributive shares that are allocable to the state. The partnership treatment differs from the treatment of the distribu-

395. This issue is analogous to the one that arises if the primary state does nothing. *See* notes 372-77 and accompanying text *supra*. The difference is that in the situation described in the text the state has a choice. In the situation that arises if the primary state does nothing, the issue is resolved by existing state law.

396. *See, e.g.,* note 375 and accompanying text *supra*.

397. *See, e.g.,* notes 372-73 and accompanying text *supra*.

398. *See* notes 67-73, 74-76, 86-87 and accompanying text *supra*.

399. *See* notes 64-145 and accompanying text *supra*.

400. *See, e.g.,* ILL. ANN. STAT. ch. 120, § 3-301(c)(2)(A) (Smith-Hurd 1974); PA. TAX REG. § 301(k)-1(4)(b), 1 PA. STATE TAX REP. (CCH) ¶ 19-518.

401. The interstate revenue loss that a state incurs if it follows the federal Subchapter S election is relatively small, because only a small percentage of corporations are Subchapter S corporations, and most of those are intrastate enterprises. For example, in 1977, of the 2,241,317 federal income tax returns filed by corporations, only 429,187 (19.1%) were filed by Subchapter S corporations. Of the $4.1 trillion in receipts reported by corporations, only $163.7 billion (3.9%) were received by Subchapter S corporations. IRS 1977 CORPORATION INCOME TAX STATISTICS, *supra* note 187 at 9, 23.

402. *See* notes 521-31 and accompanying text *infra*.

403. *See, e.g.,* MO. ANN. STAT. § 143.181(5) (Vernon 1976).

tive share entirely as business income in only one respect. Under the partnership approach, the items of corporate net income that are subject to specific allocation rules are allocated in the hands of the shareholders under those rules, and not as business income at the corporate level.[404] The result under the partnership approach is the same as when the entire corporate income is *both* allocated and apportioned, and not merely apportioned, at the corporate level.[405]

When shareholders are nonresidents of Florida and the corporation is a resident of Florida and is also present in another state, the analysis is the same as if the corporation were a resident only of Florida.[406] If Florida institutes a partial shareholder income tax, it will encounter the same questions as Ohio and Pennsylvania. If Florida continues its present system, neither nonresident shareholders nor resident shareholders will be subject to income tax.

3. *Corporation Resident in Secondary State And Its Shareholders Resident in Primary State*

(a) Primary state does nothing.—If full integration is adopted at the federal level and the primary state—the state in which the shareholders are resident—does nothing in response to the adoption of full integration, the effect of full integration depends not only on the particularities of the state tax system, but also on the response of the secondary state to full integration.

(b) Primary and secondary states do nothing—Ohio as primary state.—If Ohio is the primary state and both it and the secondary state do nothing, the effect of full integration depends on the identity of the secondary state. If the secondary state is Florida or Pennsylvania, the residents of Ohio who are shareholders in the Florida or Pennsylvania corporation will not be taxed by Florida or Pennsylvania, but they will include their distributive shares of the net income of the Florida or Pennsylvania corporation in their Ohio individual incomes. This poses no problems for Ohio in addition to those already discussed.[407]

The secondary state may be like Illinois, which has an income tax system similar to the Ohio system. In this case, Illinois might or might not tax Ohio residents who are shareholders in the Illinois corporation on their distributive shares of the net income of the corporation. Taxation is determined by the interpretation of the provisions of the Illinois or Ohio tax law relating to the allocation of

404. *See* notes 372-73 and accompanying text *supra.*
405. *See* OHIO REV. CODE ANN. § 5747.20 (Page Supp. 1975).
406. *See* note 393 and accompanying text *supra.*
407. *See* notes 230-89, 369-406 and accompanying text *supra.*

these distributive shares of nonresidents.[408] No problem arises if the net effect of the interpretation is that Illinois does not tax the distributive shares. Alternatively, if Illinois does tax those distributive shares, Ohio shareholders can claim a credit against their Ohio income taxes for the tax imposed by Illinois,[409] and revenues shift from Ohio to Illinois.

(c) Primary and secondary state do nothing—Pennsylvania as primary state.—If both Pennsylvania, as the primary state, and the secondary state do nothing, the identity of the secondary state determines the effect of full integration. If the secondary state is Florida or a state with an income tax system similar to that in Pennsylvania, such as North Carolina, the residents of Pennsylvania who are shareholders in the Florida or North Carolina corporation will not be taxed by Florida or North Carolina. These shareholders will be required to include only dividends received from the corporation in their Pennsylvania individual incomes,[410] a procedure that does not differ from the current situation.

If the secondary state is Ohio, the result is the same as if Ohio were the primary state,[411] except that the Pennsylvania individual incomes of the shareholders include only the dividends paid by the corporation and the tax credit is limited to the Ohio income tax attributable to those dividends.[412] Thus, the undistributed portion of the distributive net income of the corporation will be taxed only by Ohio. When it is later distributed as a dividend, it will be included in Pennsylvania individual income. Since the shareholder at that time should be able to claim a credit for the Ohio income tax imposed on the dividend,[413] however, revenue shifts from Pennsylvania to Ohio.

(d) Primary and secondary state do nothing—Florida as primary state.—If neither Florida, as the primary state, nor the secondary state do anything, the effect of full integration will vary. If inaction by the secondary state does not result in taxation by that state of the distributive shares of corporate net income of nonresident shareholders,[414] there will be no effect. If the inaction by the secondary state results in taxation by that state of nonresident shareholders' divi-

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408. *See* notes 372-77 and accompanying text *supra.*

409. *See* OHIO REV. CODE ANN. § 5747.05(B) (Page 1973).

410. *See* 72 PA. CONS. STAT. ANN. § 7303(a)(5) (Purdon Supp. 1977).

411. *See* notes 408-09 and accompanying text *supra*.

412. *See* 72 PA. CONS. STAT. ANN. § 7314 (Purdon Supp. 1977).

413. Problems will arise in determining which portion of the corporate net income taxed by Ohio is distributed as a dividend. Rules similar to those for determining earnings and profits at the federal level might be needed. *See* I.R.C. §§ 312, 316. A very narrow interpretation of the Pennsylvania tax law providing credits for taxes paid to other states would deny any credit to the shareholders.

414. This would occur in a state with an income tax system similar to the systems in Florida or Pennsylvania, or a state with an income tax system similar to the system in Ohio, if

dends and undistributed corporate net income,[415] Florida shareholders will pay individual income tax to the secondary state without having a Florida income tax liability against which to credit that tax.

(e) Primary state does nothing—secondary state rejects integration.—If the secondary state rejects full integration, it will not tax the primary state shareholders on their interests in the secondary state corporation. This result is no different than under current law.

(f) Primary state does nothing—secondary state adopts integration.—If the secondary state adopts full integration,[416] the effects on Ohio, Pennsylvania, Florida, and their resident shareholders are the same as if those three states were primary states, with Ohio as the secondary state that does nothing in response to full integration, but interprets its tax laws concerning allocation of the distributive net income attributable to a nonresident shareholder such that it requires a nonresident shareholder to pay an Ohio income tax on that distributive share.[417]

(g) Primary state rejects integration.—If full integration is adopted at the federal level and the primary state—the state in which the shareholders are resident—rejects full integration, the effect depends on the response of the secondary state to full integration. If the secondary state, by action or inaction, does not tax the undistributed net income attributable to a nonresident shareholder,[418] no effect will occur. The tax results will be the same as under current law. If the secondary state taxes the full distributive share of the corporate net income attributable to a nonresident shareholder,[419] a credit problem arises. The primary state generally permits a credit against its income tax only for taxes paid to another state on income also taxed by the primary state.[420] The primary state shareholders, therefore, will be unable to claim a credit for the taxes paid to the secondary state on the undistributed portion of their distributive shares of the corporate net income until that portion of the income is distrib-

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the state interprets its allocation provisions to treat the distributive share of corporate net income as a dividend.

415. This would occur in a state with an income tax system similar to the Ohio system if the state interprets its allocation provisions to treat the distributive share of corporate net income as business income.

416. An exception to this example would be Florida "adopting" integration by doing nothing in response to the adoption of integration at the federal level. *See* note 393 and accompanying text *supra*.

417. *See* notes 409, 411-13, 415 and accompanying text *supra*.

418. This would occur in a state that rejects integration or a state described in note 414 *supra*.

419. An example would be a state that adopts integration. *But see* notes 415 & 416 *supra*.

420. *See, e.g.*, 72 PA. CONS. STAT. ANN. § 7314 (Purdon Supp. 1977).

uted as a dividend.[421]

(h) Primary state adopts integration.—If full integration is adopted at the federal level and the primary state adopts full integration,[422] the effect is determined by the response of the secondary state to full integration. If the secondary state does not tax the undistributed net income attributable to a nonresident shareholder,[423] no effect occurs since the tax results will be the same as under current law. If the secondary state taxes the full distributive share of the corporate net income attributable to the nonresident shareholder,[424] the primary state shareholders will claim a credit against their primary state income tax liabilities for the income taxes paid to the secondary state on their distributive shares of the corporate net income.

4. Corporation Resident in Primary and Secondary States And Its Shareholders Resident in Primary State.—Adoption of full integration at the federal level complicates the issue that arises when the corporation is a resident only in the secondary state with the question of how to allocate and apportion the corporate income. A series of issues also arises concerning the availability or measure of tax credits for income taxes paid to other states.

If both the primary and secondary states do not tax the shareholders on the undistributed net income of the corporation,[425] the tax results and allocation problems will be no different than under current law.

If the secondary state[426] does not tax shareholders on the undistributed net income of the corporation, but the primary state does,[427] a problem arises. The primary state will tax shareholders who are residents in the primary state on their shares of the entire net income of the corporation.[428] If, however, the secondary state taxes the portion of the corporation's net income properly allocable to the secondary state,[429] the shareholders in the primary state will be unable to claim that tax as a credit against their primary state income tax liabilities. To this extent, a portion of the net income of the corporation will be subject to double taxation.[430] If the secondary state, by its

421. *See* notes 411-13 *supra* for a similar fact pattern.
422. *But see* note 416 *supra*.
423. *See* note 418 *supra*.
424. *See* note 419 *supra*.
425. *See* note 418 *supra*.
426. *Id.* An analysis based on these four categories is limited because each state encounters a combination of all four.
427. *See* note 419 *supra*.
428. A state has jurisdiction to tax its residents on all income no matter what the source.
429. Allocation problems identical to those under current law exist.
430. If the primary state is concerned with this result, it can adopt a pass-through credit system. *See* I.R.C. § 902.

inaction, taxes neither the corporation nor its shareholders on the portion of the corporate net income properly allocable to the secondary state, no special problems are created for the primary state.[431]

An interesting issue arises if the primary state[432] does not tax shareholders on the undistributed net income of the corporation while the secondary state does.[433] The secondary state will tax the shareholders who are residents in the primary state on the portion of their shares of the corporate net income that is properly allocable to the secondary state.[434] If, however, the primary state, by its inaction,[435] taxes neither the corporation nor its shareholders on corporate net income, the shareholders resident in the primary state will be unable to claim a credit for the income taxes they pay to the secondary state. This results from a limitation in most state tax laws permitting the credit only for income taxed in both states.[436] The result is undesirable from the perspective of the primary state because under current law, only the primary state would tax the shareholders' portions of the corporate income distributed as dividends.[437] If the primary state taxes the portion of the corporation's net income properly allocable to the primary state,[438] no problem arises because each state taxes the income properly allocable to it, one in the hands of the corporation and the other in the hands of the shareholders.

Two problems arise if the primary state also taxes resident shareholders on dividends received from the corporation. One is the double taxation of the portion of corporate net income allocable to the primary state. This result, however, is not a problem from the perspective of the primary state because it is an intended result. The second problem is a complication in the computation of the credit for income taxes paid to other states. Since the shareholders resident in the primary state are taxed on all dividends from the corporation,[439] they will seek a credit for the taxes paid to the secondary state on the portion of the corporate net income allocable to the secondary state.[440] The dilemma is whether the distributive share taxed by the secondary state is income also subject to taxation by the primary state within the meaning of the credit provision.[441] The situa-

431. The double taxation problem does not exist in this situation.

432. *See* note 418 *supra*.

433. *See* note 419 *supra*.

434. *See also* notes 394-400 and accompanying text *supra*.

435. An example would be a state with an income tax system similar to that in Florida or Pennsylvania.

436. *See, e.g.*, OHIO REV. CODE ANN. § 5747.05(B)(1) (Page 1973).

437. Under current law, states do not tax dividends paid to nonresidents. Dividends are therefore taxed by the home state of the shareholders. *See* note 400 *supra*.

438. *See* note 429 *supra*.

439. *See* note 428 *supra*.

440. *See* note 419 and accompanying text *supra*.

441. *See* note 436 and accompanying text *supra*.

tion is further complicated if the dividend is paid in a taxable year subsequent to the year in which the secondary state taxes the corporate net income from which it is paid. A narrow interpretation of the tax credit provision would deny the credit and cause double taxation of the corporate net income allocable to the secondary state.[442] A broader interpretation of the tax credit provision would permit the credit.

If both the primary and secondary states tax shareholders with respect to distributed and undistributed net income of the corporation,[443] no serious problem arises. The primary state will tax resident shareholders on their shares of the entire corporate net income,[444] but will allow a tax credit for the taxes paid by the shareholders to the secondary state on their shares of the corporate net income properly allocable to the secondary state.[445]

C. Dividend Credit

1. Corporation Resident in Primary State And Its Shareholders Residents of Secondary State.

(a) Primary state does nothing.—If the dividend credit method of integration is adopted at the federal level and the primary state—the state in which the corporation is resident—does nothing in response, several issues arise.

If the primary state is Ohio, the nonresident shareholder is not required to include the dividend in Ohio taxable income.[446] A question arises, however, on the allocation of the federal corporate income tax attributable to the dividend that the shareholder has included in federal taxable income.[447] If the state tax law is interpreted to allocate the federal corporate income tax to sources outside Ohio, the result is no different than under current law.[448] A contrary interpretation results if Ohio taxes the nonresident shareholder on the federal corporate income tax included in income. This raises problems for the secondary state, which are discussed in connection with the third category, in which the shareholders are residents of the primary state.[449]

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442. The primary state might intend this result. It impedes, however, the attempt of the secondary state to eliminate double taxation of corporate earnings distributed as dividends.

443. *See* notes 422-24 and accompanying text *supra* for an illustrative case.

444. *See* note 428 *supra*.

445. *See* notes 424-25 and accompanying text *supra*.

446. *See* OHIO REV. CODE ANN. § 5747.20(B)(4) (Page Supp. 1975).

447. *See* notes 206-08 and accompanying text *supra*. The issue is moot if the federal "gross-up" provisions are placed in section 78 of the Internal Revenue Code and the state tax law presently excludes the section 78 "gross-up" from state taxable income. *See* note 203 *supra*.

448. *See* note 437 *supra*.

449. *See* notes 469-89 and accompanying text *infra*.

With Pennsylvania as the primary state, the result is the same as under present law because the nonresident shareholder is not required to include the dividend in Pennsylvania taxable income.[450] The issue concerning the federal corporate income tax included in shareholder income does not arise because Pennsylvania taxable income is computed independently of the federal base.

If the primary state is Florida, no problems arise because Florida has no individual income tax.

(b) Primary state rejects integration.—Adoption of the dividend credit method of integration at the federal level and the primary state's rejection of integration causes no change in the taxation of the resident corporation and its nonresident shareholders. Their tax treatment will continue as under current law in the primary state.[451]

(c) Primary state adopts integration.—Adoption of the dividend credit method of integration at the federal level and in the primary state creates an interesting constitutional question concerning the treatment of the nonresident shareholder.[452] The issue is whether primary state taxation of nonresident shareholders with respect to dividends received from corporations resident in the primary state violates the commerce and due process clauses of the federal constitution.[453] Although contrary arguments can be advanced,[454] the decisions of the United States Supreme Court in *Wisconsin v. J.C. Penney Co.*[455] and *International Harvester Co. v. Wisconsin Department of Taxation*[456] indicate that the primary state may tax nonresident shareholders on dividends attributable to corporate net income arising from sources within the primary state.[457] The *J.C. Penney*

450. *See* note 400 *supra.*
451. *See* note 379 *supra.*
452. In New York, the constitution might prevent taxation of the nonresident shareholder. *See* Letter from James H. Tully, Jr., Commissioner of Taxation and Finance, State of New York, to James E. Maule (January 11, 1978) at 4 (on file at the Dickinson School of Law), concerning section 3 of article XVI of the New York Constitution, the relevant text of which appears in note 359 *supra.*
453. *See* notes 381-82, 384 and accompanying text *supra.*
454. Penniman & Heller, State Income Tax Administration 27 (1959) (no authority cited). *But see* Note, *Multistate Taxation of Personal Income,* 111 U. PA. L. REV. 974 (1963).
455. 311 U.S. 435 (1940).
456. 322 U.S. 435 (1944).
457. The Court in *International Harvester* stated,

> In taxing such distributions [of corporate earnings], Wisconsin may impose the burden of the tax either upon the corporation or upon the stockholders who derive the ultimate benefit from the corporation's Wisconsin activities. Personal presence within the state of the stockholder-taxpayers is not essential to the constitutional levy of a tax taken out of so much of the corporation's Wisconsin earnings as is distributed to them. A state may tax such part of the income of a non-resident as is fairly attributable either to property located in the state or to events or transactions which, occurring there, are subject to state regulation and which are within the protection of the state and entitled to the numerous other benefits which it confers. And the privilege

and *International Harvester* decisions concerned the same state tax on the corporation, which was measured as a percentage of dividends paid. In both cases, the Supreme Court reiterated the rationale of *Wisconsin Gas & Electric Co. v. United States*:[458] "[W]here the earnings of a Wisconsin corporation doing business solely in Wisconsin are the source of the dividends, the State's power to tax their transfer and impose that tax upon the stockholder cannot be doubted."[459]

Since the constitutional questions should be resolved in favor of the primary state, that state must decide whether it will continue nontaxation of nonresident shareholders on the dividends from the primary state corporation, or whether it will tax the nonresident shareholder and permit a credit for the state corporate income tax attributable to the dividend.[460] The latter approach alleviates double taxation of the corporate net income. The former approach also allieviates double taxation unless the secondary state taxes the nonresident shareholders on the dividend from the primary state corporation without providing a credit.[461]

2. *Corporation Resident in Primary and Secondary States And Its Shareholders Resident in Secondary State*

(a) Primary state does nothing.—If the dividend credit method of integration is adopted at the federal level and the primary state—one of two states in which the corporation is resident—does nothing in response, the issues presented are the same as in the situations in which the corporation is resident in the primary, but not secondary, state.[462]

(b) Primary state rejects integration.—If the federal government adopts the dividend credit method of integration and the pri-

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of receiving dividends derived from corporate activities within the state can have no greater immunity than the privilege of receiving any other income from sources located there.

We think that Wisconsin may constitutionally tax the Wisconsin earnings distributed as dividends to the stockholders.

322 U.S. at 441-42.

458. 322 U.S. 526 (1944).

459. *Id.* at 530-31. All three decisions might be distinguishable because the *corporation,* not the shareholders, was required to file a return and remit the tax withheld from the distributed dividends. Dicta in the cases indicate that such a distinction is tenuous. Moreover, states might determine that it is administratively advantageous to require corporations to withhold under a dividend credit method of integration.

460. In either event, Ohio must take steps to remove from the taxable income of the shareholders the federal corporate taxable income otherwise included therein. *See* notes 301-02 and accompanying text *supra.*

461. No problem occurs if the secondary state is Florida. The credit might not be of much use to the shareholders if their income tax liabilities to the primary state are less than their income tax liabilities to the secondary state.

462. *See* notes 446-50 and accompanying text *supra.*

mary state proceeds to reject integration, the tax treatment of the corporation and its nonresident shareholders from the perspective of the primary state will continue as under current law.[463]

(c) Primary state adopts integration.—If the dividend credit method of integration is adopted both at the federal level and in the primary state, several questions arise in addition to the issues concerning treatment of the nonresident shareholder when the corporation is resident in the primary, but not secondary, state. The issues arise if the primary state decides to tax the nonresident shareholder on the dividend from the corporation and permit a credit for the state corporate income tax attributable to the dividend. First, the primary state must decide how it will determine the portion of the dividend that is attributable to corporate net income from sources within the primary state.[464] Presumably, the allocation would conform to the allocation used by the corporation in determining its income tax liability to the primary state,[465] although this approach is not without complications.[466] Second, the primary state must decide how it will determine the portion of state corporate income tax that is attributable to the dividend paid to the nonresident shareholder and subject to income taxation by the primary state.[467] In all likelihood, the state corporate income tax included in the income of the nonresident shareholder, and subsequently allowed as a credit, will be the tax paid on the income of the corporation from which the dividend taxed by the state is paid.[468]

3. *Corporation Resident in Secondary State and Its Shareholders Resident in Primary State*

(a) Primary state does nothing.—If the federal government adopts the dividend credit method of integration and the primary

463. *See* note 379 *supra*.

464. The federal constitution limits taxation by the primary state of the portion of the corporate net income attributable to income from sources within the secondary state. *See* text accompanying note 393 *supra*.

465. The formula might be as follows:

$$\begin{array}{c}\text{Portion of}\\ \text{dividend taxed}\\ \text{by primary}\\ \text{state}\end{array} = \text{Dividend} \times \frac{\text{Corporate net income from sources within primary state}}{\text{Total corporate net income}}$$

466. If more than one taxable year is involved there must be a complicated tracing of sources of corporate net income and application of the formula in note 465 *supra* to each particular year. *See* note 413 *supra*.

467. The amount of state corporate income tax so determined is included in the state taxable income of the nonresident shareholder and allowed as a credit against the tax liability of the shareholder.

468. *See* notes 465-66 *supra*. Special rules would be needed to determine the state corporate income tax attributable to the dividend if the dividend is paid from the earnings of more than one taxable year.

state does nothing in response, the effect of integration depends not only on the identity of the state, but on the response of the secondary state to the dividend credit method of integration.

(b) Primary and secondary states do nothing—Ohio as primary state.—If both Ohio, as the primary state, and the secondary state do nothing, the effect of the dividend credit method of integration depends on the identity of the secondary state. If the secondary state is Florida, the residents of Ohio who are shareholders in the Florida corporation will not be taxed by Florida, but will include the dividend and federal corporate income tax attributable to the dividend in their Ohio individual incomes.[469] This does not pose any problems for Ohio in addition to those already discussed.[470]

If the secondary state is Pennsylvania, the residents of Ohio who are shareholders in the Pennsylvania corporation will not be taxed by Pennsylvania, and no special problems are caused for Ohio. If the secondary state is a state with an income tax system similar to Ohio's, such as Illinois, the residents of Ohio who are shareholders in the Illinois corporation may or may not be taxed by Illinois on the federal corporate income tax included in the income of the shareholders.[471] If Illinois does not tax the federal corporate income tax, no problem arises. If Illinois taxes the federal corporate income tax, however, the Ohio shareholders will claim a credit for the taxes paid to Illinois if Ohio also taxes the federal corporate income tax. If Ohio does not tax the federal tax, Ohio taxpayers do not claim a credit,[472] but they will pay income taxes to Illinois on ownership of an Illinois corporation that they do not pay under current law.[473]

(c) Primary and secondary state do nothing—Pennsylvania or Florida as primary state.—If either Pennsylvania or Florida is the primary state and neither the primary nor the secondary state responds, the effect of the dividend credit method of integration differs from the effect under current law in one aspect. If the secondary state is Ohio and it interprets its tax law to require the Pennsylvania or Florida shareholders to pay Ohio income tax on the federal corporate income tax included in federal taxable income, Pennsylvania shareholders will not be able to credit the Ohio tax against their Pennsylvania tax liabilities. Florida shareholders will have no Florida income tax liability against which to credit that tax. Both Pennsylvania and Florida shareholders will, however, be paying income

469. *See* notes 205-08 and accompanying text *supra.*
470. *See* notes 446-49 and accompanying text *supra.*
471. *See* notes 446-49 and accompanying text *supra.*
472. A state permits a credit only for income taxed both by it and by the state that imposes the income tax. *See* note 420 and accompanying text *supra.*
473. The tax is unintended and accidental and, for that reason, probably is not justifiable.

taxes to Ohio for ownership of an Ohio corporation. They do not pay these taxes under current law.[474]

(d) Primary State does nothing—Secondary state rejects integration.—The primary state shareholders will not be taxed on interests in the secondary state corporation if the secondary state rejects the dividend credit method. This result is the same as under current law.

(e) Primary state does nothing—Secondary state adopts integration.—If the secondary state adopts the dividend credit method of integration, the primary state and its resident shareholders are affected in several ways. The primary state need not act if the secondary state decides not to tax nonresident shareholders' corporate dividends.[475] If the secondary state taxes nonresident shareholders' dividends from the corporation, the effect depends on the identity of the primary state.

If the primary state is Florida, the result is that resident shareholders pay to the secondary state a tax that they do not pay under current law.[476]

If the primary state is Pennsylvania, it must resolve a complicated tax credit issue. The tax credit that Pennsylvania residents can claim is the portion of the tax paid to the secondary state on the dividend.[477] One aspect of the problem is that part of the secondary state tax liability of the Pennsylvania shareholder involves the inclusion of the corporate state income tax liability in income. The second aspect of the problem concerns the allocation of the secondary state dividend credit liability of the Pennsylvania shareholder on the dividend to the secondary state.[478]

If the primary state is Ohio, it faces the same problems as Penn-

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474. *See* note 473 *supra*.

475. *See* note 460 *supra*.

476. This does not occur if in the secondary state the state dividend credit of the shareholder exceeds the state income tax liability of the shareholder on the dividend and the state dividend credit.

477. *See* note 420 and accompanying text *supra*.

478. For example, assume the corporation has one shareholder and is taxed by the secondary state at a five percent rate. The corporation has $200 of income before federal tax liability, and thus pays $10 of state income tax. The corporation pays a $100 dividend to the Pennsylvania shareholder. The secondary state taxes the Pennsylvania shareholder on $105 ($100 plus $5 corporate tax attributable to dividend), at a rate of six percent for a tax liability of $1.30 ($6.30 less $5 corporate tax). Pennsylvania taxes the shareholder on the $100 dividend. The issue is whether the credit should be $1.30 (actual tax paid to secondary state), $6.00 (secondary state tax on the dividend ignoring dividend credit, i.e., 6% of $100), or $5.95 (the $6.00 tax less 100/105 of the $5.00 dividend credit). Presumably it should be $1.30, but this is not an evident result. This ignores the fact that in the absence of the dividend credit method of integration the secondary state would not have taxed the Pennsylvania shareholder.

In any event, Pennsylvania legislators and tax administrators probably will not appreciate the complexity added to its tax law and forms as a result of the actions of another state.

sylvania, in addition to the question of whether the federal corporate income tax included in Ohio taxable income of the shareholder is subject to income taxation.[479]

(f) Primary state rejects integration.—If the dividend credit method of integration is adopted at the federal level and the primary state—the state in which the shareholders are resident—rejects integration, the response of the secondary state determines the effect of the dividend credit method of integration. If the secondary state does not provide for a dividend credit method of integration,[480] the tax results will be the same as under current law. If the secondary state, by its inaction, taxes the federal corporate income tax included in the federal taxable income of the shareholder, the effect will be the same as when Ohio, as the secondary state, interprets its tax laws to produce the result.[481] If the secondary state adopts a dividend credit method of integration, the effect for Ohio and Pennsylvania is the same as that described when Pennsylvania does nothing and the secondary state adopts a dividend credit method of integration.[482] Since Florida does not have an individual income tax, these effects will not occur in Florida, but the tax liabilities of its shareholders to the secondary state will be altered.[483]

(g) Primary state adopts integration.—Adoption of the dividend credit method of integration at the federal level only by the primary state can produce several results, depending upon the response of the secondary state. If the secondary state does not adopt a dividend credit method of integration,[484] there is no effect on the primary state unless the secondary state is Ohio and it taxes the federal corporate income tax included in the federal taxable income of the shareholder.[485] If the secondary state adopts a dividend credit method of integration and decides to tax nonresident shareholders' dividends,[486] the result will be a complication of the state income tax credit for taxes paid to another state.[487]

479. *See* notes 447-49 and accompanying text *supra.*

480. This would occur in states with income tax systems similar to those in Pennsylvania or Florida.

481. *See* notes 471-74 and accompanying text *supra.* There will be one simplification in the fact pattern described at text accompanying note 473 *supra*, because one of the states with an income tax system similar to Ohio's will not tax the federal corporate income tax attributable to the dividend and, thus, there will be no credit for taxes paid to another state.

482. *See* notes 477-78 and accompanying text *supra.*

483. Whether there is an increase or decrease depends on the relation of the income tax rates of the corporation and the rates of its shareholders.

484. An example would be a state that rejects integration or a state described in note 480 *supra.*

485. *See* notes 471-74 and accompanying text *supra.*

486. *See* note 460 *supra.*

487. *See* notes 477-78 and accompanying text *supra.*

A second and more important effect of the adoption of a dividend credit method of integration by the primary state is a consequence of the fact that the corporation has no tax liability to the primary state.[488] The dividend, therefore, is included in the primary state income of the shareholders as it is under current law, but there is no state corporate income tax credit for the shareholders to claim against their income tax liabilities to the primary state.[489] The primary state adopting the dividend credit method of integration must rely on the secondary state to provide relief to the corporation in situations falling within this category.

4. Corporation Resident in Primary and Secondary States And Its Shareholders Resident in Primary State.—If the dividend credit method of integration is adopted at the federal level, the effect in this category is a compounding of two types of issues: the issues arising when the corporation is resident only in the secondary state and the issue of allocation and apportionment of corporate income. In most situations in which the corporation is resident only in the secondary state and the shareholders are resident in the primary state, little is added by the fact that the corporation is subject to income taxation by the primary state. The one exception is that the primary state adopting the dividend credit method of integration will not face the problem that arises if the corporation has no inome tax liability to the primary state. The shareholders will include all or a portion of the income tax liability of the corporation to the primary state in their primary state taxable incomes and will be permitted to claim a credit in that amount against their income tax liabilities to that state.

D. Dividend Deduction

Adoption of a federal dividend deduction method of integration would present the states with several problems. Regardless of its response to the adoption of the dividend deduction method of integration by the federal government, the primary state will not be concerned with the response of the secondary state, because the dividend deduction method of integration affects only corporate income tax.

If the primary state adopts the dividend deduction method of integration, it must decide whether it should allow the deduction for dividends paid to nonresident shareholders.[490] Although permitting

488. This is because the fact pattern involves a corporation that is not resident in and, thus, not subject to taxation by the primary state. *See* note 178 and accompanying text *supra.*

489. *See* Letter from James H. Tully, Jr., Commissioner of Taxation and Finance, State of New York, to James E. Maule (January 11, 1978) at 4 (on file at the Dickinson School of Law).

490. This problem is not unlike that encountered at the federal level regarding whether nonresident alien shareholders should be eligible for income tax integration. *See* Comm. on Corporations of the Tax Section of the N.Y. St. Bar A., *supra* note 1, at 47-48; Letter from

such a deduction produces a revenue loss because the nonresident shareholders do not have a tax liability to the primary state, the proponents of integration point out that double taxation of corporate earnings would not necessarily be completely eliminated if the deduction for those dividends were denied.[491]

The primary state adopting the dividend deduction method of integration will also need to provide a method for determining what portion of the dividends paid by the corporation are allocable to the primary state.[492] Presumably, the deduction should be the same proportion of the dividends as the proportion of corporate taxable income before dividends and state income taxes allocable to the primary state bears to the entire taxable income of the corporation before dividends and state income taxes.[493] The computation could be more complex if the state adopts a precise approach by requiring a tracing of the corporate taxable income from which dividends are paid[494] and applies a separate proportion fraction to the taxable income from each taxable year.[495]

E. *Dividend Exclusion*

If a dividend exclusion method of integration is adopted at the federal level, the states face several issues. Primary states will not be concerned from a technical standpoint with the response of the sec-

James H. Tully, Jr., Commissioner of Taxation and Finance, State of New York, to James E. Maule (January 11, 1978) at 4 (on file at the Dickinson School of Law).

491. Proponents of income tax integration have not yet addressed this specific issue in the state context, but this position is an almost inevitable result of their reasoning. *See* notes 4-6 and accompanying text *supra.* A constitutional equal protection question might be raised by a corporation whose shareholders are nonresidents. The state will emphasize that it taxes only residents' dividends and that therefore its double taxation of corporate earnings, eliminated by allowing a deduction for dividends distributed to resident shareholders, does not exist for dividends distributed to nonresident shareholders.

492. The issue arises only if the corporation is a resident in the secondary as well as the primary state. The remainder of a full dividend deduction would be provided by the secondary state since it, and not the primary state, is responsible if double taxation occurs because of its action or inaction. The federal government, by adopting the dividend deduction method of integration, has determined that the cause of double taxation is the taxation at the corporate level of distributed dividends.

The issue is analogous to that at the federal level concerning whether a deduction should be permitted for dividends paid from tax-exempt income. *See* McLure, *Integration of Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals, supra* note 1, at 565.

493. The peculiar nature of the tax law or tax policy of a particular state might require the use of an income figure from an earlier or later point in the computation of taxable income, such as taxable income after state income taxes.

494. Special rules similar to those provided for computing earnings and profits would be required. *See* note 413 *supra*.

495. The complexity can be illustrated by considering a corporation that in its first taxable year does business only in the secondary state, pays no dividends, and has after-tax net income of $100. In its second taxable year, the corporation does business in both the primary and the secondary states, has no income from either state, but distributes a $50 dividend to its shareholders. The issue is whether the primary state should allow a dividend deduction in that situation.

ondary state because the dividend exclusion method of integration affects only individual income tax. This is not changed by either adoption or rejection of a dividend exclusion method of integration. From a policy standpoint, however, the primary state must be concerned with the response of the secondary state. If the secondary state does not provide the exclusion for its residents who are shareholders in a primary state corporation,[496] the goals of the primary state are thwarted to that extent.[497]

A technical issue that arises regarding the dividend exclusion method of integration is whether the primary state should permit the exclusion of dividends attributable to income not taxed by the primary state. The adoption of such a rule would require complex rules of attribution and special provisions for dividends paid in a year other than that in which earned.[498] The primary state does not benefit, however, from adopting complex attribution rules that provide, in effect, for a partial dividend exclusion. If the secondary state taxes resident shareholders of the primary state on the portion of the dividend attributable to corporate earnings from the secondary state, which it is not likely to do,[499] the primary state would permit its resident shareholders to claim an income tax credit for those taxes. Since the net effect of the credit is to remove that portion of the dividend from primary state taxable income, a partial denial of the exclusion would be counterproductive. Similarly, if the secondary state does not tax the resident shareholder of the primary state on the portion of the dividend attributable to corporate earnings from the secondary state, the primary state, by excluding that portion from the dividend exclusion, continues to impose double taxation on certain corporate income.

If the primary state has no individual income tax, it has no problems because it has a dividend exclusion method of integration[500] already in effect.[501]

496. Even if the secondary state rejects integration, it will continue, as it does under present law, to not tax primary state residents on dividends whether or not the corporation is subject to income taxation by the secondary state. A constitutional equal protection question could be raised by the nonresident corporation whose shareholders resident in the secondary state are not permitted to exclude dividends received from the corporation—if the corporation has standing to raise the issue—but the secondary state can reply as it would to the question raised by the dividend deduction method of integration. *See* note 491 *supra*.

497. The primary state cannot provide a credit to the shareholders who are residents of the secondary state because those shareholders are not subject to income taxation by the primary state.

498. *See* notes 494-95 and accompanying text *supra*.

499. States generally do not tax dividends received by nonresident shareholders. *See* note 400 and accompanying text *supra*. Thus, the primary state resident would not be taxed by the secondary state.

500. The word "exclusion" is misleading because there is no individual gross income from which the dividend can be excluded.

501. The state that has no individual income tax will not encounter the partial dividend

F. Split Corporate Tax Rates and Repeal of the Corporate Income Tax

If a split rate method of integration is adopted at the federal level or if the federal corporate income tax is repealed, the states will encounter no problems in the context of the federal relationship among the states. Both methods of integration affect only the corporate income tax. The only open issues are whether the state will adjust its corporate income tax in response to a split rate method at the federal level, and whether the state will repeal its corporate income tax[502] in response to repeal of the federal corporate income tax.

VII. Maintenance of State Revenues and Administrative Simplicity in A Federal System

A. Introduction

It is possible that various states may be satisfied with the immediate effects on state income taxation if the federal government adopts income tax integration.[503] It is also possible that a state may be content to adopt or reject integration. A state could decide that to follow any of the three courses of action—no response, adoption of integration, or rejection of integration—would be disastrous or extremely burdensome to the state.[504] Thus, the state might seek alternative courses of action. Some of the proposed alternative arrangements are feasible only if many states agree to pursue them. These arrangements are not mutually exclusive and assorted combinations of their features provide additional possible arrangements. Finally, other arrangements exist that have not occurred to the author and which will be suggested only when other writers address them.

B. Federal Revenue Adjustments

The federal revenue sharing mechanism provides a method of offsetting revenue shifts that will occur as a consequence of the adop-

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exclusion problem discussed in the text accompanying note 498 *supra* because its decision not to tax any dividends already has been made.

502. *See* note 379 *supra*.

503. This article speaks in terms of actions, decisions, and analyses by the state for reasons of simplicity. More precisely, it is the legislature, Governor, and citizenry of a state that decide, act, and analyze.

504. A state should consider that if federal income tax integration is as successful as its proponents predict it will be, the benefits to the national economy caused by federal income tax integration should filter through to the states in the form of increased tax bases—such as higher incomes, more transactions subject to sales taxes, and increases in property tax assessments—without as great an increase in state expenditures. It is beyond the scope of this article to measure that effect.

tion of income tax integration at the federal level.[505] Adjustments in distribution formulas can be made to compensate states in which revenues decline. The same purpose can be achieved outside of the federal revenue sharing mechanism, but requires diversion of some funds from revenue sharing to the other mechanism. Use of revenue sharing, however, would avoid creation of another bureaucracy to handle federal-state fiscal relations. The system used in West Germany to equalize the financial strengths of the states offers guidance for the designers of a federal adjustment system. Modifications to the West German equalization system would be necessary because the fiscal relationships and allocations of tax jurisdiction among the national and state governments in West Germany differ from those in the United States.[506]

C. The Carter Commission Proposals

1. State Withdrawal From the Corporate Income Tax.—When the Carter Commission in Canada addressed itself to the problems the provinces would encounter if income tax integration were adopted at the federal level, it suggested that those problems could be alleviated if the provinces repealed their corporate income taxes. The Carter Commission suggested that the states could recoup their revenue losses[507] in other ways,[508] but it is not clear that any of the forty-six states with corporate income taxes would be willing to abandon the corporate income tax base. Aside from the fact that state revenues would be jeopardized,[509] this arrangement would leave unresolved many of the problems concerning the individual income tax that are raised by integration. Presumably, states would also forego taxing dividends. Even though that arrangement would solve many administrative problems, states probably would react in opposition, as did the provinces of Canada.

2. Piggybacking.—Another arrangement proposed by the Carter Commission to alleviate the problems that the provinces would encounter is federal collection of income taxes on behalf of the provinces. This piggybacking approach appears to solve most of the administrative problems and revenue shifts caused by the adoption of integration at the federal level. Some states, however, have

505. No revenue shifts will occur if every state takes steps to reject income tax integration, a highly unlikely possibility.

506. *See* notes 172-74 and accompanying text *supra.*

507. The revenue loss would be shifted to the federal level.

508. Royal Commission on Taxation, 6 Report 196 (Ottawa 1966).

509. Currently, the federal government does not administer any tax that produces as much revenue as the state corporate income tax and that the federal government is willing to forego in favor of the states.

constitutional limitations[510] and problems in computing the share of each state in the revenue collected by the federal government would persist. If the piggybacking provisions in the Internal Revnue Code were used, it would be necessary for each state to adopt integration and the problems involving taxation of nonresident shareholders and computing tax credits would remain.[511] The prospects for this arrangement seem dim, since the states have been reluctant to utilize the existing piggybacking provisions of the Internal Revenue Code.[512]

3. Federal Credit for State Corporate Tax.—As a third arrangement for alleviating the problems the provinces would encounter if income tax integration were adopted at the federal level, the Carter Commission suggested that the national government should adopt a dividend credit method of integration that permits shareholders to claim a credit against their federal tax liabilities for a standard rate of state income taxes paid by the corporation on the income from which dividends are paid. This arrangement permits the states to reject integration and avoid the revenue shifts and administrative problems posed by integration, but does not allow them to thwart federal efforts to decrease or eliminate the double taxation of corporate income distributed as dividends. The drawback posed by this arrangement is that it decreases federal revenues without affecting the state income taxes that account for double taxation of corporate income at the state level. The federal government could recoup the revenue by eliminating revenue sharing, but the benefits of the revenue sharing redistribution would flow to corporate shareholders and not the public at large. States probably would hesitate to approve such a step.

D. Multistate Tax Compact Amendments

The Multistate Tax Compact provides an opportunity for states to solve some of the problems that arise when income tax integration is considered in the context of the federal relationship among the states. At present, the Multistate Tax Compact is a model act that has been adopted in whole or in part by at least thirty states to eliminate some of the problems involved with the taxation of the multistate taxpayer. The problems of the nonresident shareholder or nonresident corporation reviewed in this article could be analyzed and studied with the expectation that a solution could be reached by a series of additional articles to the Compact. The possibility of

510. *See* note 181 *supra*.
511. *See* notes 369-502 and accompanying text *supra*.
512. *See* NATA REPORT, *supra* note 231.

resorting to the Multistate Tax Compact to solve the problems of reacting to income tax integration is doubtful. Most commentators agree that the Multistate Tax Compact is not the best device for solving interstate problems.[513] Amendments to the Compact are almost impossible because legislative action by each state is necessary.[514] Amendments to the Multistate Tax Compact deserve attention by the states when integration is adopted at the federal level, but it is unlikely that use of the Compact will be considered an adequate arrangement.

E. Reciprocal Agreements

States may consider the reciprocal agreement to eliminate some of the interstate complexities of income tax integration. Presently, a number of states have entered into reciprocal agreements with one, two, or even a dozen other states in an effort to simplify tax administration, both for the state and the taxpayer.[515] Most of these agreements concern wages, salaries, and similar income earned by a resident of one of the states from sources within the second state.[516] Generally, the agreement permits one state to exempt certain nonresident wages from its income tax if the home state of those nonresidents exempts wages of residents of the first state from its income tax. This arrangement eliminates withholding and tax credit problems. It would be advantageous in many situations for states to enter similar agreements with respect to dividends.

The reciprocal agreement approach has three drawbacks. First, each state must enter a separate agreement with every other state. This drawback, however, has not deterred states that have entered into a number of agreements, albeit with neighboring states.[517] Second, states standing to lose revenue by not taxing nonresident shareholders on their distributive shares or distributions of net income of a resident corporation are not apt to welcome a reciprocal agreement unless it is with a state having similar revenue loss expectations. Finally, the computation of exempt dividends under a reciprocal agreement would be more complex than the computation of exempt wages. Wage records are usually straightforward and if an employee performs services in two states, the employer must keep separate

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513. *See* O. OLDMAN & F. SCHOETTLE, STATE AND LOCAL TAXES AND FINANCE 663 (1974).

514. *Id.*

515. *See, e.g.,* OHIO REV. CODE ANN. § 5747.05(A)(3) (Page 1973).

516. *Id. See, e.g.,* the Ohio Reciprocal Agreements with Indiana, Kentucky, Michigan, Pennsylvania, and West Virginia, dated Jan. 12, 1972, Jan. 7, 1972, Jan. 13, 1972, Dec. 29, 1972, and Jan. 20, 1972, reproduced in 1 OHIO STATE TAX REP. (CCH) ¶ 15-215.40, 15-215.90.

517. This would occur if Ohio entered into five reciprocal agreements with neighboring states. *See* note 516 *supra.*

records in any event.[518] At present, however, similar records concerning dividends and the sources of the income out of which they are paid are not as readily available. In the absence of a reciprocal agreement the complicated dividend records probably will be required nonetheless. The reciprocal agreement deserves careful consideration.[519]

F. User Charges

A state that is concerned about the revenue loss caused by those methods of income tax integration that eliminate or curtail the corporate income tax might explore possible increases in the use of user charges. User charges are service fees charged by a state for providing services to an individual, corporation, or other entity. Since user charges can be imposed on nonresidents, use of this approach resolves most of the problems concerning the effect of income tax integration on the source of income tax revenues that provide state services.[520]

G. Devices to Administer Taxation of Nonresident Shareholders

The manner in which some of the states subject the nonresident shareholders of Subchapter S corporations to income taxation suggests certain arrangements that the states might employ to combat administrative difficulties posed by income tax integration. In Georgia[521] and Kansas,[522] a Subchapter S corporation is taxed on the portion of its income attributable to nonresident shareholders unless those shareholders agree to pay income tax to the state on their distributive shares of the corporate income. In Idaho[523] and Indiana,[524] nonresident shareholders are required to pay tax to Idaho or Indiana

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518. An employer would have to keep separate records for purposes of state unemployment insurance tax and the payroll factor in the three-factor income tax apportionment formula.

519. The reciprocal agreement would not be required for all methods of integration, but would be most beneficial for full integration and the dividend credit method of integration.

520. *See* notes 342-48 and accompanying text *supra*. A discussion of user charges is beyond the scope of this article, but the opportunity they present for solving some of the problems caused by integration deserves mention. For excellent explanations and analyses of user charges, *see* PUBLIC PRICES FOR PUBLIC PRODUCTS (S. Mushkin ed. 1972); Goetz, *The Revenue Potential of User-Related Charges in State and Local Governments*, in BROAD-BASED TAXES: NEW OPTIONS AND SOURCES (R.A. Musgrave ed. 1973); Kafoglis, *Local Services Charges: Theory and Practice*, in STATE AND LOCAL TAX PROBLEMS 164 (H.L. Johnson ed. 1969); Stockfish, *Fees and Service Charges As a Source of City Revenues: A Case Study of Los Angeles*, 13 NAT'L TAX J. 97 (1960).

A device similar to the user charge is the special district. *See* Mitchell, *The Use of Special Districts in Financing and Facilitating Urban Growth*, 5 URB. LAW. 185 (1973); Novak, *A Model Special Assessment Law*, 1 GOV'T FINANCE 8 (1972).

521. GA. CODE ANN. § 92-3102(b)(ii) (Supp. 1977).

522. KAN. STAT. § 79-32,139 (1969).

523. IDAHO TAX REG. § 22(d)(2), IDAHO STATE TAX REP. (CCH) ¶ 13-076.

524. *See* Circular IT-18, 1 IND. STATE TAX REP. (CCH) ¶ 16-016.

on their distributive shares of the corporate net income. In Idaho, however, if the nonresident shareholders do not pay the tax, the Subchapter S corporation is taxable on the income attributable to those shareholders.[525] Indiana requires the Subchapter S corporation[526] to withhold income tax on distributions that it makes to nonresident shareholders.[527] The Indiana withholding provision resolves the administrative issue of compliance by nonresidents, but the problems of computing the amount of corporate income for which the nonresident shareholder is liable[528] remain unresolved. Interestingly, some states—Iowa,[529] Missouri,[530] and Virginia[531]—require nonresident shareholders of Subchapter S corporations to pay income tax on their distributive shares of the corporate net income and apparently have no more difficulty with this tax administration than they do with nonresident partners.[532]

VIII. Conclusion

The adoption of income tax integration[533] at the federal level will produce significant consequences for state income tax systems. Revenue shifts and administrative difficulties are an inevitable result whether a particular state ignores, adopts, or rejects the federal government's choice of a system of integration.[534] A state may decide to negate the effects of federal integration on the state tax system or, alternatively, it may determine that the wiser option is to conform to the federal scheme. Steps can be outlined and implemented to pursue either goal. Regardless of the path taken, difficulties will certainly arise since not all fifty states will react harmoniously. The states have demonstrated, however, that they are able to cope with tax law revision at the federal level.[535] The adoption of integration may be the supreme test of the states' flexibility, but the problems to be faced are not insurmountable. A probing examination of the var-

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525. IDAHO TAX REG. § 22(d)(3), IDAHO STATE TAX REP. (CCH) ¶ 13-076.

526. Indiana also imposes this requirement on other corporations that are exempt from income tax because the corporate net income is included in the state taxable income of the shareholders.

527. IND. CODE ANN. § 6-3-4-13 (Burns Code Ed. Supp. 1977).

528. *See* notes 369-502 and accompanying text *supra*.

529. IOWA CODE ANN. § 422.36(5) (1971).

530. MO. ANN. STAT. § 143.181(5) (Vernon 1976).

531. VA. CODE § 58-151.013(f)(3) (Supp. 1977).

532. A tax administrator in any of those states probably would point out that it is more difficult to subject nonresidents than residents to compliance and enforcement. *See* McKessy, *supra* note 7, at 378.

533. This particular conclusion does not apply to the split-rate method of integration.

534. These revenue shifts and administrative difficulties for the most part will not arise for states that have no income taxes and states whose corporate and individual income tax systems do not conform to the federal income tax base. *See* note 176 *supra*. On December 16, 1980, only eleven states were in these categories. 41 STATE TAX REV. (CCH) No. 51, at 4-7 (December 16, 1980).

535. *See* notes 90-132, 521-32 and accompanying text *supra*.

ious responses and complex arrangements that are available will set the groundwork for state legislators and tax administrators to develop and implement solutions when the time arrives.

APPENDIX I

Illustration (1) Average corporate tax rate exceeds average individual tax rate

	No dividends	40% dividends	Maximum dividends
a. Prior to full integration			
1. Corporation income before taxes	$1,000.00	$1,000.00	$1,000.00
2. State tax (4%)	40.00	40.00	40.00
3. Federal taxable income	960.00	960.00	960.00
4. Federal tax (48%)	460.80	460.80	460.80
5. Available for dividends	499.20	499.20	499.20
6. Dividends	-0-	199.68	499.20
7. Shareholder income	-0-	199.68	499.20
8. State tax (2½%)	-0-	4.99	12.48
9. Total state tax (lines 2 & 8)	40.00	44.99	52.48
b. Immediate effect of full integration			
1. Corporate income before taxes	1,000.00	1,000.00	1,000.00
2. State and federal tax	-0-	-0-	-0-
3. Shareholder distributive share	1,000.00	1,000.00	1,000.00
4. State tax (2½%)	25.00	25.00	25.00
c. Decrease in state tax revenue as immediate effect of full integration (line a9 minus line b4)	15.00	19.99	27.48

Illustration (2) Average individual tax exceeds average corporate tax rate

	No dividends	40% dividends	Maximum dividends
a. Prior to full integration			
1. Corporation income before taxes	$1,000.00	$1,000.00	$1,000.00
2. State tax (2%)	20.00	20.00	20.00
3. Federal taxable income	980.00	980.00	980.00
4. Federal tax (48%)	470.40	470.40	470.40
5. Available for dividends	509.60	509.60	509.60
6. Dividends	-0-	203.84	509.60
7. Shareholder income	-0-	203.84	509.60
8. State tax (4%)	-0-	8.15	20.38
9. Total state tax (lines 2 & 8)	20.00	28.15	40.38
b. Immediate effect of full integration			
1. Corporation income before taxes	1,000.00	1,000.00	1,000.00
2. State and federal tax	-0-	-0-	-0-
3. Shareholder distributive share	1,000.00	1,000.00	1,000.00
4. State tax (4%)	40.00	40.00	40.00
c. Increase (decrease) in state tax revenue as immediate effect of full integration (line b4 minus line a9 or line a9 minus line b4)	20.00	11.85	(.38)

APPENDIX II

		No dividends	40% dividends	Maximum dividends
	a. Prior to dividend credit method of integration			
1.	Corporation income before taxes	$1,000.00	$1,000.00	$1,000.00
2.	State tax (4%)	40.00	40.00	40.00
3.	Federal taxable income	960.00	960.00	960.00
4.	Federal tax (48%)	460.80	460.80	460.80
5.	Available for dividends	499.20	499.20	499.20
6.	Dividends	-0-	199.68	499.20
7.	Shareholder income	-0-	199.68	499.20
8.	Shareholder income	-0-	4.99	12.48
9.	Total state tax (lines 2 & 8)	40.00	44.99	52.48
	b. Immediate effect of dividend credit method of integration			
1.	Corporation income before taxes	1,000.00	1,000.00	1,000.00
2.	State tax (4%)	40.00	40.00	40.00
3.	Federal taxable income	960.00	960.00	960.00
4.	Federal tax (48%)	460.80	460.80	460.80
5.	Available for dividends	499.20	499.20	499.20
6.	Dividends	-0-	199.68	499.20
7.	Federal tax attributable to dividends	-0-	184.32	460.80
8.	Shareholder income	-0-	384.00	960.00
9.	State tax (2½%)	-0-	9.60	24.00
10.	Total state tax (lines 2 & 9)	40.00	49.60	64.00
	c. Increase in state tax revenue as immediate effect of dividend credit method of integration (line b10 minus line a)	-0-	4.61	11.52